GaiaLens

A GaiaLens Market Study

Preparing for Full ESG Integration

AUGUST 2022

Management Report of Findings from an extensive study of 200 of the largest asset owners in the US and Western Europe completed in H1 2022.

Foreword

In this study, we have explored the ESG integration progress of the largest asset owners on both sides of the Atlantic. This comprehensive report captures where Chief Investment Officers and Heads of Sustainability are on their journeys to full ESG integration.

We have been able to probe the areas of difficulty in gathering and making sense of the increasing incoming deluge of ESG data from asset managers. We also found a wide array of sustainability reporting frameworks and indices in use, and a burgeoning demand for greater standardisation and comparability between ESG scores, ratings and reporting systems.

Delving deeper, we found widespread evidence of ESG data gaps and scoring inconsistencies. At GaiaLens, we understand that you cannot manage what you cannot measure accurately and it's clear from even a cursory glance at our underlying survey that many asset owners are still struggling to make sense of all the ESG data that it is now being sent to them by the hundreds of asset managers they have handed mandates to. Turning all the data into benchmarkable and actionable intelligence is the next big challenge for asset owners, our report finds.

We hope you find this report as interesting and eye-opening as we did. Please do get in touch if you would like to hear more about what GaiaLens is offering to help bridge the data-driven intelligence divide to ensure ESG performance improvement in your portfolios does not come at the expense of their investment performance.

Yours Sincerely,

Gordon Tveito-Duncan
Co-founder & Director of ESG Technology
Email: gordon.tveitoduncan@gaia-lens.com

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SECTION 1

Setting the Scene

Introduction

In the final quarter of 2021, GaiaLens embarked on a nine month market research project to investigate the progress of a representative sample of Chief Investment Officers (CIOs), Heads of ESG Integration and Heads of Sustainability working within the largest asset owners in the US and Western Europe, in terms of aligning investments with Environmental, Social and Governance (ESG) goals.

Working with US-based independent investment market research house Beresford Research, a decision was made to set a realistic target of reaching 100 CIOs and relevant senior decision-makers from within the top 250 asset owners by Assets Under Management (AUM). Half of these (i.e.,50 CIOs) were to be located in organisations headquartered in Western Europe and the other half had to be US-based.

A further 100 CIOs were to be sourced from the top 251 to 500 asset owners by AUM– again with 50 of these working for institutions based in Western Europe and a further 50 from US-based asset owners. Therefore, the minimum quotient for this study was 200 senior ESG decision-makers within the top 500 asset owners in Western Europe and the US.

The above quotient target of reaching key ESG decision-makers across 200 major asset owners, evenly divided between Western Europe and the US, was judged to be achievable within a month which was ruled to be important in view of the fast moving nature of ESG integration projects.

Questionnaire design & methodology

Following extensive discussions with Beresford Research from mid-October 2021, the market research questionnaire, consisting of seven pre-qualifier questions and 20 core questions, was finalised by early December ready to go into the field. The methodology selected to collect all responses was to be CATI (Computer Aided Telephone Interviewing) to assure target respondent levels were achieved and that survey responses were accurate and surveys were fully completed.

In field for 5 weeks

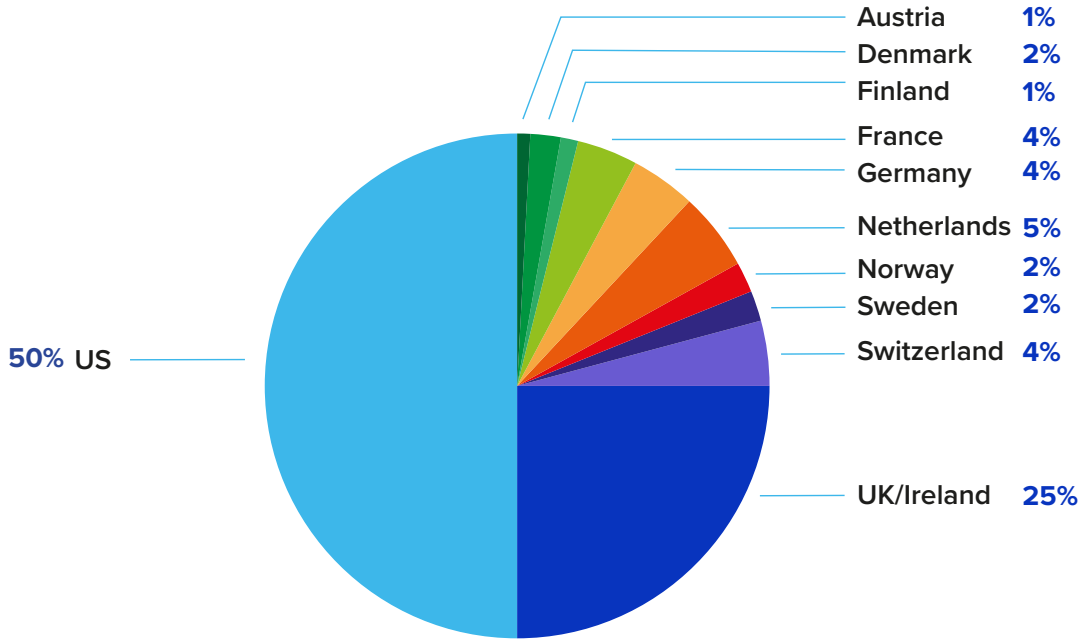
The questionnaire went into the field on 6th December 2021 and the quotient of 200 respondents was reached on 10th January 2022, whereupon the study was closed.

Over 50% of respondents were CIOs

105 of the 200 respondents (53 per cent) were CIOs. Of the 105 CIOs responding – 54 were working for US-based organisations and 51 in Western Europe. Of those working in Western Europe more than half (29 in total) were based either in the UK or Ireland.

Nearly a quarter (24 per cent) were Heads of Sustainability and nearly the same percentage (23 per cent) were Heads of ESG Integration.

FIGURE #1: Where is your organisation headquartered?



Of the US respondents over half (56 per cent) were based in Eastern US, just over a quarter (26 per cent) from Central US and 20 per cent from Western US.

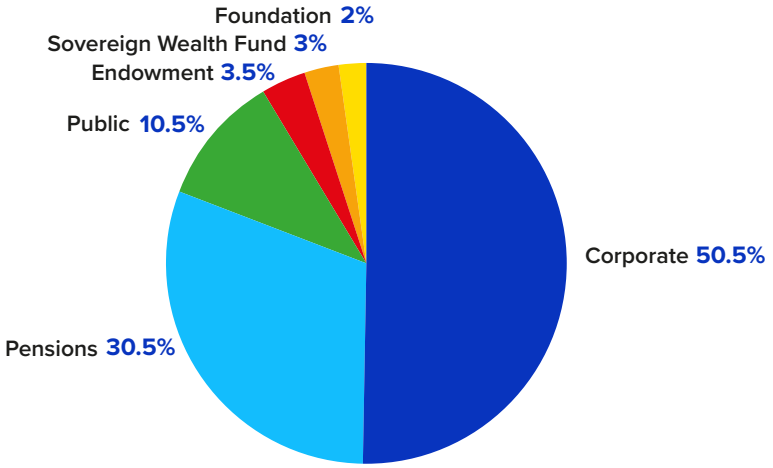
AUM clusters

Although we were targeting the top 250 and the next 250 asset owners by AUM evenly, the study also captured what that sample looked like in terms of the spread of AUM ranges. The below figure revealed that exactly 50 per cent of respondents were working for asset owners with AUM of US $500 billion (bn) or more. Total estimated AUM represented by the 200 largest asset owners in Western Europe and the US which this study captures totalled US $50.7 trillion (tn).

FIGURE #2: What are your firm's Assets Under Management?:

As part of the pre-qualification questions, the research probed the types of asset owner they were. It was perhaps no surprise that four out of every five asset owner which GaiaLens reached held corporate assets (50.5 per cent) or were pension funds (30.5 per cent). However, this leaves Sovereign Wealth Funds, arguably slightly under-represented, with just three per cent of respondents. Those holding public/government-owned assets represented 10.5 per cent of all 200 respondents.

FIGURE #3: Which type of asset owner are you?



The study probed the types of pensions which held the most assets and found that despite the declining numbers of Defined Benefit (DB) pensions still open to new contributions, nearly 38 per cent (37.7 per cent globally and 41 per cent in the US) of all pensions assets were still associated with legacy DB pensions. This left 62.3 per cent which are now in Defined Contribution (DC) pension schemes which are the ones open to the vast majority of workers under the age of 60.

SECTION 2

Preparing the Groundwork for ESG Integration

Nearly two-thirds (60 per cent) of the largest US and Western Europe-based asset owners were already building dedicated ESG portfolios and more than half (55 per cent) were offering ESG fund options today.

Yet despite the fact that this largescale ESG investment shift is already underway, just a quarter (25 per cent) of all asset owners had integrated ESG scoring into their existing investment manager selection processes and only 29 per cent had made requests for all their existing investment managers to present their ESG strategies and plans to them. Furthermore, less than a quarter (22 per cent) were directly addressing shareholders' ESG concerns through increased dialogue with them on the topic.

FIGURE #4: Please confirm whether you have implemented any of the following strategies. *Please select all relevant:*

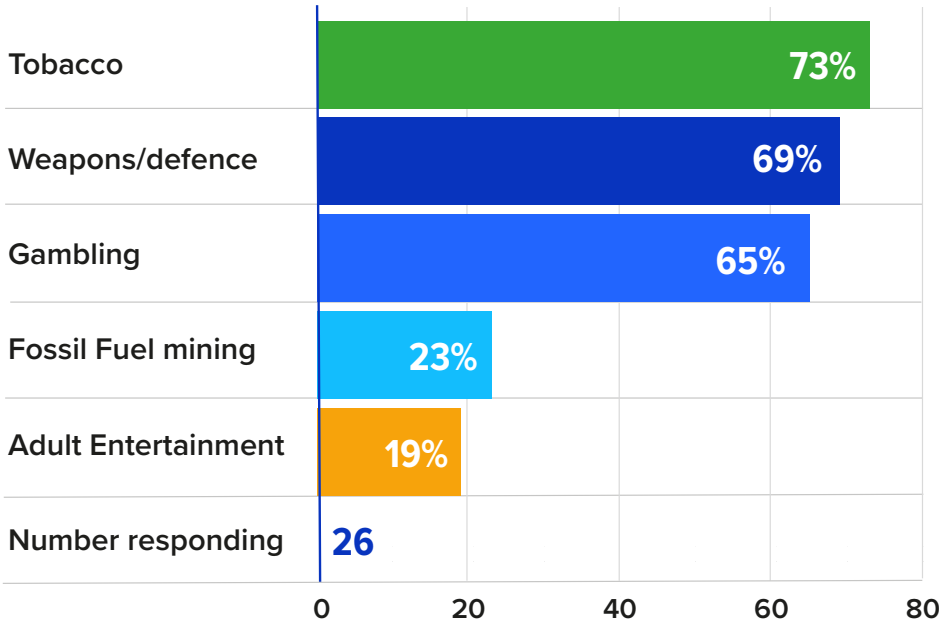
The findings indicate that, although portfolio changes are being made by over half of asset owners already, a good deal of the preparatory groundwork which you would expect to have been completed first (i.e., the rules and standards setting and due diligence) appears not to have been done in many cases.

Is this because things are moving too fast to put those checks and balances in place first, or is it because asset owners simply do not see the value in putting the systems, processes, scoring and screening systems in place before ruling investments and asset managers in or out? The question is worthy of further exploration.

Negative screening hitting tobacco and weapons manufacturers hardest

Just 13 per cent of asset allocators have applied negative screening of certain types of investments or sectors; while just over 18 per cent have already divested out of certain sectors which it no longer wishes to be associated with. Amongst those using negative screening, nearly three-quarters (73 per cent) were screening out tobacco companies and 69 per cent weapons/defence equipment suppliers.

FIGURE #5: Which types of investments are negatively screened?
Select all that apply

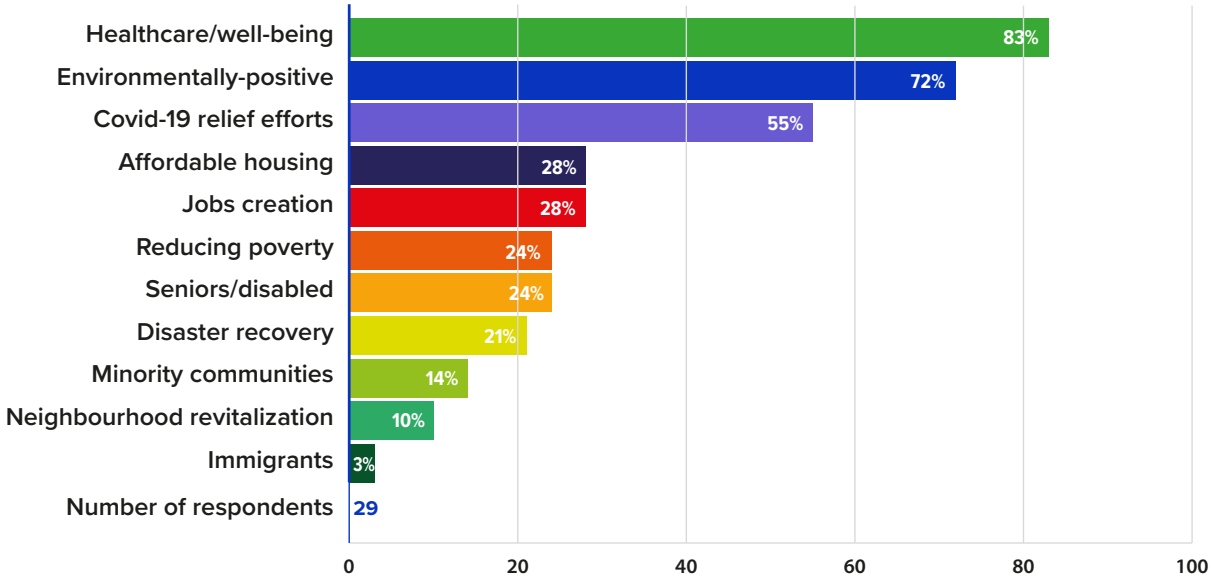


Taken from the sample of 26 (or 13%) of the whole sample of 200 respondents who are applying negative screening

Healthcare sector biggest winner from positive screening

Approximately one in six (15 per cent) of the top 500 asset owners which GaiaLens reached are applying positive screening techniques as part of their ESG realignment work. The biggest winner in terms of being screened in were healthcare and wellbeing stocks: 83 per cent of the firms applying positive screening were favouring healthcare sector investments. While 72 per cent were screening in stocks which were 'good for the environment'. Interestingly, 88 per cent of European asset owners favoured environmentally-sound stocks, whereas just half of US-based asset allocators favoured green investments.

FIGURE #6: Which types of investment are positively screened in?
Select all that apply



Taken from the sample of 29 (15 per cent) of all 200 survey respondents which are applying positive screening

There are some indications that social and inequality of opportunities/housing and jobs were higher up US asset owners' 'to do' lists and were more likely to be positively-screened into investment selections over there. Whereas European asset owners seemed more attuned to improving healthcare and protecting the environment.

1 in 3 US asset owners don't believe ESG realignment can deliver higher returns today

US-based asset owners remain more sceptical about whether ESG investment realignment can deliver higher returns than prior benchmarks, at least in the short-term: a third (33 per cent) of US-based asset owner senior decision-makers believed ESG adoption was negatively impacting returns at the start of 2022. While just over half that number (17 per cent) believed this amongst Western Europe-based decision-makers.

A further nine per cent of decision-makers remained unsure as to whether higher returns could be achieved through ESG realignment. Taken together the higher returns through ESG realignment sceptics averaged 34 per cent across all 200 CIOs and senior decision-makers questioned in early January 2022.

Surely the fact that senior decision-makers within over a quarter of the largest asset owners across Western Europe and the US don't believe that it makes investment sense to migrate to more ESG positive investments, suggests that there is still a good deal of work to do to square the circle between saving the planet and/or building a more equitable society, and protecting investment growth.

SECTION 3

ESG Data Quantity, Quality & Scoring Consistency Key Constraints

Data quantity, quality and scoring consistency key concerns in measuring ESG performance

Gaps in the provision of publicly-listed companies' social and environmental performance records remains the top concern for CIOs tasked with determining the ESG performance of the organisations they are selecting for investment.

An average of 36 per cent of asset owners (40 per cent in Western Europe and 32 per cent in the US) registered this data gap as a primary concern for them. CIOs were asked to only give their top three concerns associated with assessing ESG performance accurately.

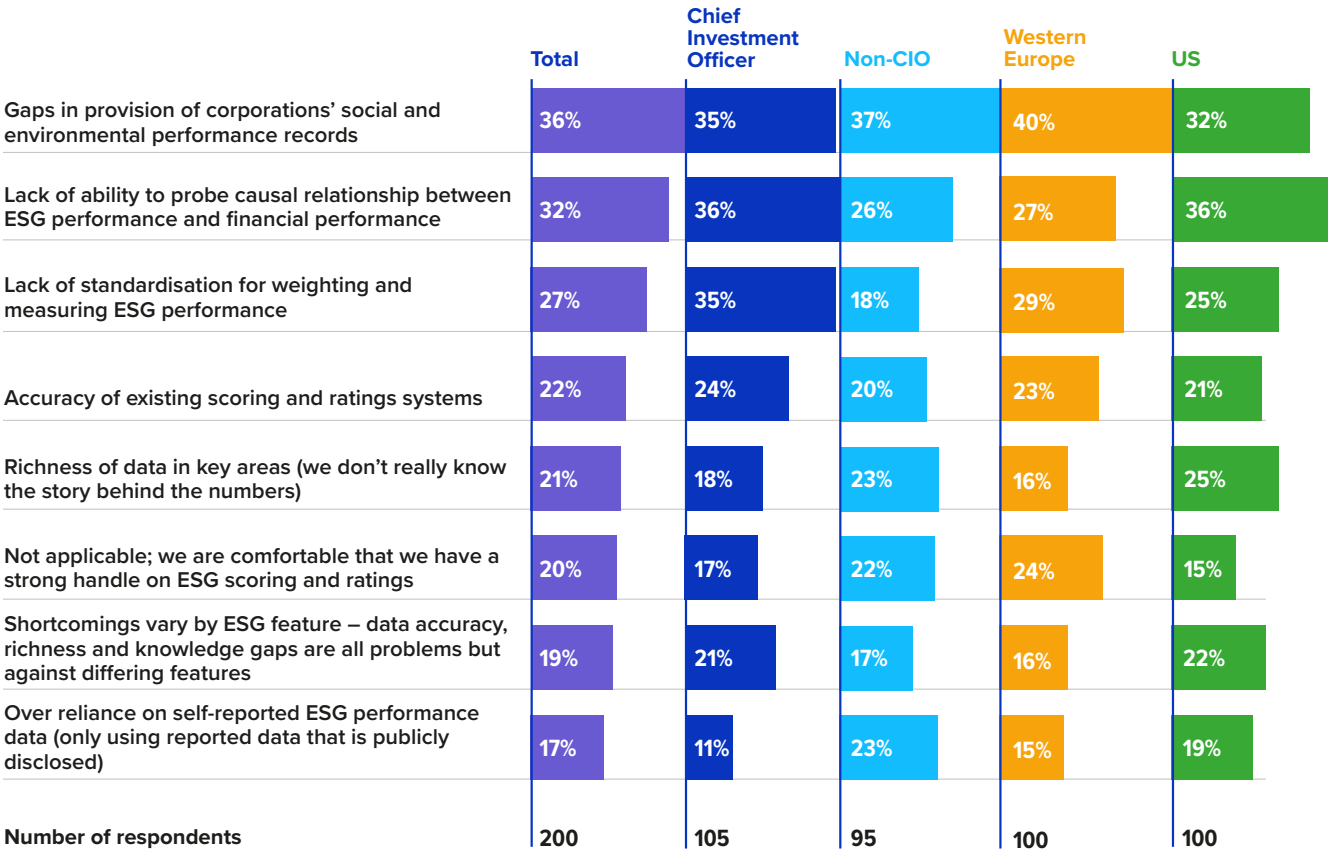
Nearly as many, an average of 32 per cent, were very concerned about their inability *'to probe causal relationship(s) between ESG performance and financial performance'*. This concern was raised as a principal concern by 40 per cent of the 100 US-based CIOs and senior decision-makers questioned.

Over a quarter, 27 per cent, included *'lack of standardisation for weighting and measuring ESG performance'* of corporations in their *'top 3*' concerns. This was a primary concern for 29 per cent of CIOs of Western Europe-based asset owners.

Nearly a quarter (22 per cent) of asset owners considered *'accuracy of existing ESG scoring and rating systems'* to be a top 3 concern. Again, in Europe this was a slightly more significant concern, with 23 per cent of CIOs there putting accuracy of scoring and ratings systems as a primary concern.

Just one in five (21 per cent) of asset owners recorded that they were happy that they had *'a strong handle on (their existing) ESG scoring and ratings'* systems.

FIGURE #7: What is your principal concern when determining ESG performance of planned investments? *Please select top three concerns only.*



Data quantity, data quality and consistent weighting/reweighting and scoring of that data remain widespread issues for asset owners. Less than a fifth of ESG decision-makers claimed to be comfortable that they have a strong handle on ESG scoring and ratings at the start of 2022. So, four in every five of the largest asset owners were experiencing data quantity, quality and/or struggling to establish a consistent, uniform method of valuing and scoring the ESG performance of their investments and portfolios.

Automatic ESG risk flagging needed

When asked what capabilities asset owners most wanted to obtain, 59 per cent of CIOs signalled that they needed 'to be able to screen and monitor portfolios of investments and flag companies with high ESG risk exposure' as a top priority. Two-thirds (65 per cent) of CIOs based in Western Europe put this in their 'Top 2' indicating that this was either 'central to our needs' or 'considerably important'.

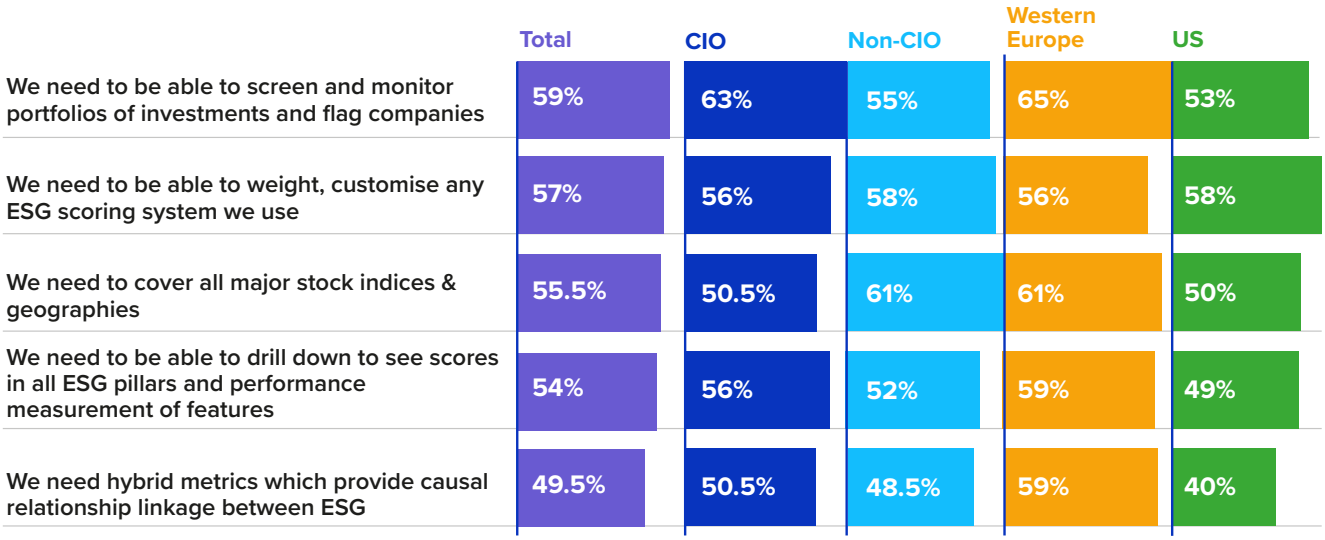
Nearly as important was the ability 'to weight and customise any ESG scoring system we use', according to pre-agreed investment strategy and priorities: an average of 57 per cent of asset owner senior decision-makers considered this 'central to our needs' or 'considerably important'.

Drill down capability requested by 54% of asset owners

Not far behind in importance was the potential to drill down to see 'raw' scores within each of the E, S and G pillars as well as features within those pillars: an average of 54 per cent of asset owners regard this drill down capability as central to their needs or considerably important.

On average, just over half (54 per cent) of asset owners regard 'hybrid metrics which provide causal relationship linkage between ESG performance and longer term financial performance' as 'central to our needs' or 'considerably important'. In Western Europe, 59 per cent of asset owner ESG decision-makers give this capability the same level of importance.

FIGURE #8: What level of transparency and comprehensiveness do you expect to see in ESG scores and ratings systems? *Factors rated in the owners' top 2 are captured here*



Gordon Tveito-Duncan, co-founder and head of ESG Technology at GaiaLens, commented:

> *"The application of ESG-linked data gathering, scoring and analysis systems by asset owners is clearly playing catch-up. There's widespread evidence of data gaps and scoring inconsistencies."*

SECTION 4

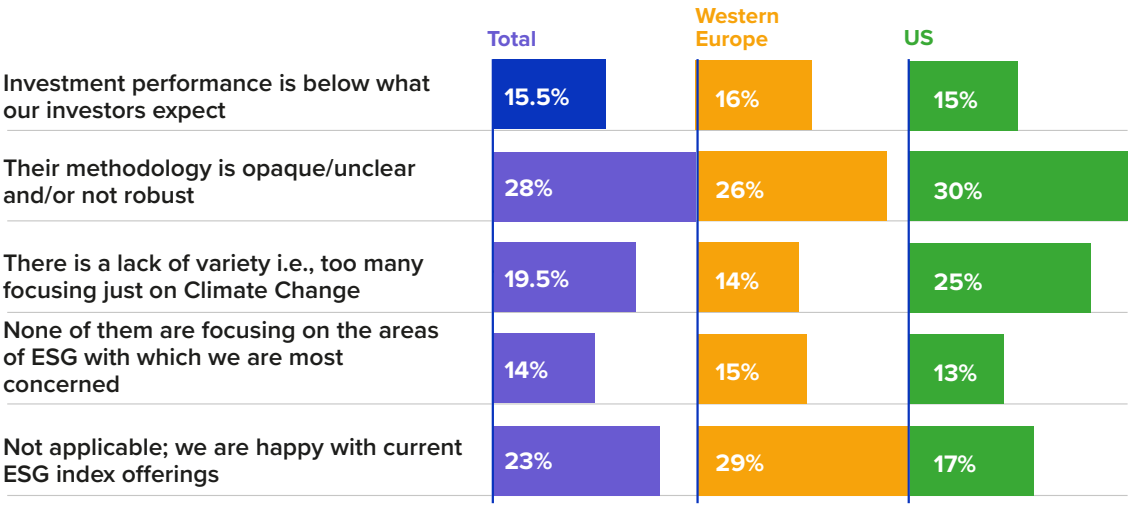
ESG Indices Evolution

Less than a quarter of asset owners are happy with current ESG indices offerings available to them

Only 23 per cent of the largest asset owners operating on either side of the Atlantic were happy with the ESG index providers they were using at the start of 2022. A higher percentage (28 per cent) declared the ESG index providers' methodologies 'unclear' and/or 'not robust'. Nearly one in five (19.5 per cent) made it clear that a more evenly balanced indexing of all ESG factors was needed – declaring 'there is a lack of variety i.e., too many focus just on Climate Change' today.

Nearly one in six (14 per cent) allocators went further to declare that 'none (of the providers) are focusing on the areas of ESG which most concern us.' Furthermore, the tussle between ESG performance and investment performance continues, with 15.5 per cent confirming that all of the ESG indexes are delivering investment performance which is 'below what our investors expect'.

FIGURE #9: What is your principal concern with ESG indices currently available? *Please select one main concern only.*



The chief concerns highlighted by ESG integration project decision-makers inside the largest asset owners, were the opaque nature of indices and the fact that too many focus on climate change ratings, to the exclusion of S & G performance ratings.

This over-focus on the environment was a more significant concern in the US where a quarter (25 per cent) of decision-makers stated that there was 'a lack of variety in indices' right now and an over-focus on climate change mitigation, as opposed to 14 per cent of Western Europe-based ESG decision-makers who expressed this as their primary concern linked to ESG indices they were currently using.

Scope for growth of Social Impact-specific indices

Close to half (46 per cent) of asset owners think that 'S' and 'G' reporting will gain significance in investment decisions during this year (US asset owners are slightly ahead on this at 47 per cent – see below Figure #10). A further 38 per cent think S and G reporting will gain significance in investment decisions during 2022.

The consensus is the current fixation on Net Zero and impact of doing business on Climate Change, will abate as asset owners broaden their focus on building a more just and equitable society, as well as a more environmentally-sustainable one.

Is ESG too broad?

From analysis of the findings, it is increasingly obvious that E, S and G is far too wide a waterfront to combine in one index meaningfully. The majority of ESG indices are focused on the E, rather than the S and the G. Poor Governance after all has been traditionally kept in check through the proxy voting rights of institutional investors.

However, this leaves a definite opening for more S-focused indices. There is a strong argument that the scene is now set for a rapid increase in the number and types of Social impact-focused indices as investors begin to articulate the key social issues that they want to affect.

Good examples of areas which might see dedicated indices emerging thick and fast are those addressing specific UN Sustainable Development Goals (SDG)-driven goals such as the eradication of poverty and promotion of equality. Modern Slavery is another that major pension and sovereign wealth funds are looking hard at integrating into their asset selections.

Studies into impact investing by US-based asset owners, found that social impact areas such as neighbourhood revitalisation and affordable housing, gained significantly increased popularity amongst investors during the pandemic (Source: Impact and ESG Investing Survey by Community Capital Management, October 2021). Institutional investors are increasingly looking for ways to move capital rapidly towards companies that provide solutions to major social and/or environmental challenges.

However, achieving impact at scale has proven to be challenging. MSCI's ESG Sustainable Impact Metrics provides a really interesting framework for doing so. It aims to measure investors' revenue exposure to sustainable impact solutions and support actionable thematic allocations in line with the UN SDGs, EU Taxonomy of Sustainable Activities and other sustainability-related frameworks.

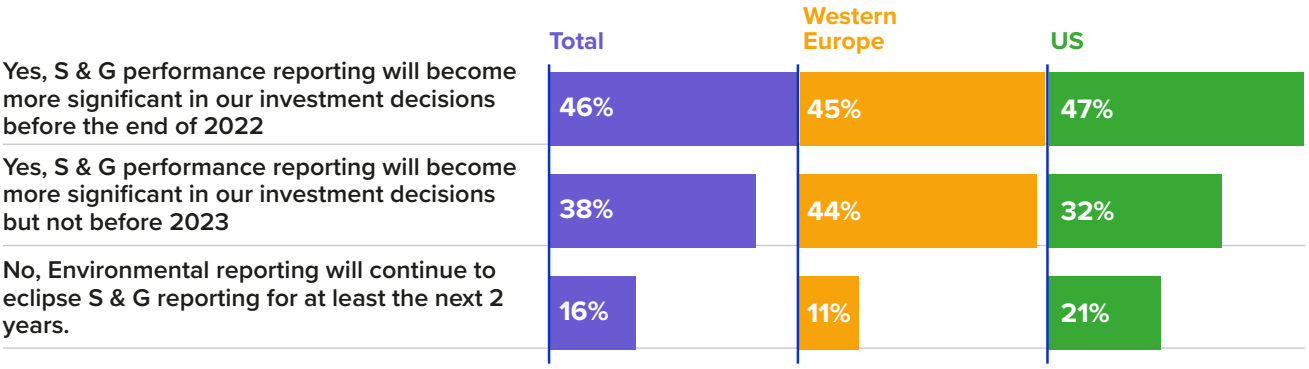
Moving capital towards companies that provide solutions to major social and/or environmental challenges also needs to be done without pushing investment performance backwards too far, too fast. One investigation GaiaLens has seen pinpoints the problems of picking very specific Social impacts like Diversity & Inclusion or Gender Equality and selecting investments based on these fairly narrow themes.

Diversity indices

Three Diversity indices already live today which were compared recently with the MSCI World Net Total Return USD Index (NDDUWI) were found to have tracked between 10.5 and 13.5 per cent below the NDDUWI index over five years. That tracking error is far too high to be of use to passive managers for example. One solution may be to ensure a balance between ESG exclusions or tilts, and the setting of tracking error limits in order to optimise passive indexes and portfolios.

Furthermore, new Diversity & Inclusion thematic indices which try to take on a global footprint could come unstuck if they apply the same scoring system for companies regardless of geographical location. In China, for example, there is no clear understanding of diversity in companies yet.

FIGURE #10: Do you expect that the Social (S) and Governance (G) pillars of ESG reporting will gain in relative importance for your organisation over the next year? *Please select one response.*



Evolution and innovation

It is clear that ESG indices are in a state of rapid evolution. It's likely that we will see a wave of index innovation as theme-specific Social and Environmental impact indices emerge. This innovation will no doubt be demanded by asset owners and managers as they develop greater maturity around articulation of the positive impacts that their investments are targeting.

The challenge will be not to set the bar so high that so many companies will be negatively screened out that investors' need to diversify will be hampered - distorting portfolios which ultimately impacts investment performance.

As with all things, ESG indices will need to find that happy medium between doing good (or at least not promoting harm to the environment and society at large) and delivering strong and consistent investment returns.

Gordon Tveito-Duncan, co-founder of GaiaLens, commented:

"It is clear from the level of dissatisfaction with ESG index providers and the wide disparity of ESG reporting frameworks being put to work, that ESG ratings remain a messy, opaque world which is riddled with data quantity and quality gaps.

GaiaLens is addressing the very significant Social and Governance data vacuum already facing institutional investors, many of whom indicated in this study that a massive focus on collecting and analysing Environmental data over recent years has left them exposed in terms of the S & G performance reporting."

SECTION 5

Sustainability Reporting Jungle

GRI Standards, UN SDGs and TCFD make up Top 3 ESG reporting frameworks

The GaiaLens asset owners study also probed which ESG reporting frameworks were in use by the largest asset owners on both sides of the Atlantic. The GRI's (Global Reporting Initiative) Standards proved to be the most popular sustainability reporting framework: 57 per cent of the largest asset allocators in Western Europe and the US are using some GRI Standards for sustainability reporting today.

The GRI Standards provide the world's most comprehensive and widely used standards for sustainability reporting. These standards help organizations understand their outward impacts on the economy, environment, and society, including those on human rights.

Organizations can either use the GRI Standards to prepare a sustainability report in accordance with the Standards or use selected standards to report information for specific users or purposes, such as reporting their climate change impacts for their investors and consumers. The standards are written in modular fashion. So, it's possible to pick and choose relevant topic-specific standards, and as long as these are completed alongside relevant GRI universal disclosures and they inform the standards body of their usage, they can submit GRI Standards-based reports free of charge.

UN SDGs used by nearly half of largest asset owners

The UN 17 Sustainable Development goals proved to be the second most popular based on GaiaLens' findings – 44.5 per cent of asset owners were using the 17 SDGs to guide their ESG reporting.

The UN SDGs or Global Goals are a collection of 17 interlinked global goals designed to provide a 'blueprint to achieve a better and more sustainable future for all'. The SDGs were set up in 2015 by the United Nations General Assembly and are intended to be achieved by 2030.

TCFD still only used by 30% of the largest asset owners

The Taskforce on Climate-related Financial Disclosures (TCFD), assembled by the Financial Stability Board following The Paris Agreement (which came out of COP24 held in December 2018) makes up the third most popular ESG reporting framework - used by exactly 30 per cent of the largest asset owners on both sides of the Atlantic.

Western European allocators lead on use of GRI, UN SDGs and TCFDs

These 'top 3' ESG reporting frameworks are all enjoying higher usage amongst Western European asset owners than US-based allocators. For example, the GRI Standards are used by 60 per cent of Western Europe-based versus 54 per cent of US-based asset owners.

Nearly half (48 per cent) of Western Europe's asset owners have applied UN SDGs for their ESG reporting, versus 41 per cent of US-based asset owners which use it. Finally, 32 per cent of Western Europe-based asset owners had begun using TCFDs as an ESG reporting framework at the start of 2022. That percentage falls to 28 per cent for US-based owners.

SASB has much higher adoption amongst US asset owners

By contrast, the SASB (Sustainability Accounting Standards Board) has nearly doubled its adoption amongst US asset owners as compared with Western Europe-based asset owners: 33 per cent of CIOs and investment decision-makers inside the largest asset owners in the US have adopted the SASB ESG guidance framework and standard, while only 19 per cent of Western Europe's asset owners are applying the SASB Standard.

The SASB Standard identifies the subset of ESG issues most relevant to financial performance in each of 77 Sustainable Industry Classification System (SICS) industry groupings They are designed to help companies disclose financially-material sustainability information to investors.

EU taxonomy used by over a quarter of Western Europe's largest asset owners at launch

The rising star in ESG reporting frameworks is likely to be the EU taxonomy which did not officially go live until 12th July 2022 but already has a strong following amongst over a quarter (27 per cent) of Europe's largest allocators; whilst only seven per cent of US allocators are using it to date.

The EU taxonomy is a classification system, establishing a list of environmentally-sustainable economic activities. It could play a key role in helping the EU increase sustainable investment and implement the European 'green deal'.

The EU taxonomy would provide companies, investors and policymakers with appropriate definitions for which economic activities can be considered environmentally sustainable. In this way, it should create security for investors, protect private investors from 'greenwashing', help companies to become more climate-friendly, mitigate market fragmentation and help shift investments to where they are most needed.

The EU SFDR (Sustainable Finance Disclosures Regulation), which is not set to apply until early 2023 after further scrutiny by the EU Parliament and the EU Council, already has achieved adoption amongst 10 per cent of the largest Western European asset owners. The European Commission adopted agreed technical standards for SFDR back in April 2021. It is to be used by financial market participants when disclosing sustainability-related information. Today's Delegated Regulation specifies the exact content, methodology and presentation of the information to be disclosed, thereby improving its quality and comparability.

Under these rules, financial market participants will provide detailed information about how they tackle and reduce any possible negative impacts that their investments may have on the environment and society in general. Moreover, these new requirements will help to assess the sustainability performances of financial products. Compliance with sustainability-related disclosures will contribute to strengthening investor protection and reducing greenwashing. This will ultimately support the financial system's transition towards a more sustainable economy.

DIY ESG reporting frameworks limited

Finally, eight per cent of US asset owners declared that they are using an ESG reporting framework they developed themselves and half that number (four per cent) of Western Europe's asset allocators have decided to develop their own ESG reporting framework. It is clear that the ESG reporting frameworks which work best tend to be the ones that maintain independence and yet are open to collaboration (take the GRI and SASB collaborative approach as good examples).

The successful ones also tend to recognise the distinct differences between different types of industries and sectors and therefore enable corporations to adjust what they report on in the light of those differences. Some, SASB for example, are also hardwired into financial reporting activities, helping companies to disclose financially-material sustainability information to investors – recognising that, for most asset owners, alpha investment performance cannot be sacrificed in the quest to improve ESG performance.

GRI – an exemplar sustainability reporting umbrella framework

GRI appears to be the current winner in terms of majority adoption amongst the largest asset owners on both sides of the Atlantic. It has been confirmed as the most widely adopted sustainability reporting framework. It is worth investigating briefly what their formula has been for driving up adoption over recent years.

Firstly, GRI is run by an independent organization with strong presence in both the US and Western Europe, perhaps partly attributed to it being set up in Boston before moving its headquarters to the Netherlands some years later. Secondly, its focus since its inception some 25 years ago, has been on developing a strong corporate and diverse stakeholder outreach and training programme.

Around 80 per cent of the world's largest 250 companies globally now use the GRI Standards – a significantly higher percentage than any of its competitors following a long term focus on corporate and partner body engagement. A comprehensive update of what was called G4 to the new GRI Standards in 2018 has worked to future-proof the standards, standardising language and creating a modular format which made navigation easier.

The fact that it is still free to use adds to its appeal, as does the fact that it has so far been translated into 12 languages, with many more to follow. It's also builds in flexibility – helping users select 'material topics' to report on that are most relevant to their company, according to which sector they are in for example.

GRI is also compatible with other reporting frameworks including TCFD, SSASB, CDP questionnaires and International Integrated Reporting Framework (IIRC) and other frameworks. As such it acts as an umbrella framework for many other sustainability reporting systems. For example, the GRI Standard is also set to absorb thinking coming out of the Corporate Sustainable Reporting Directive (CSRD) and the European Green Deal which may be finalised during next year. This will make it mandatory for a large swathe of European companies to report on sustainability impacts and goals.

Collaboration, consolidation and modular flexibility needed to ease ESG reporting burden

Collaboration and consolidation appears to be the key to easing ESG reporting burden and increasing data comparability between sustainability reporting frameworks. One fifth (19 per cent) of asset owners in our study recognise that each sector and geography has different focus areas and starting points for key factors like decarbonisation. This demands re-weighting by both sector and geography.

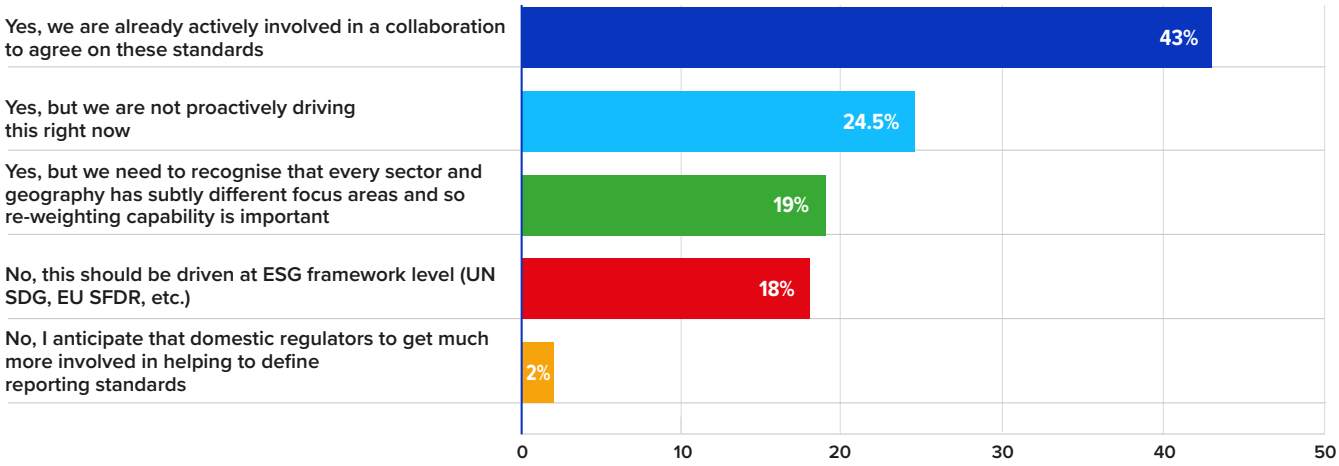
Frameworks must allow for contextual issues like whether you are penalising the energy companies for being the largest problem as regards global emissions or incentivising them to make the positive shifts to green energy which are much more seismic for them (and the Planet), than say a financial services business operating in the City of London which is transitioning to net zero by 2035.

Collaboration between asset owners, corporations and reporting frameworks

Nearly half (43 per cent) of the largest asset owners were already actively involved in collaborating to agree on ESG reporting standards and benchmarks for comparability, as collaboration seems to be the watchword for agreeing ESG reporting standards which work for all stakeholders while preserving good governance and protecting or enhancing society and the environment at large.

Only a minority were backing leaving the key reporting frameworks to crack ESG measurement & reporting standardisation alone - less than one in every five ESG change decision-maker inside the largest asset owners on both sides of the Atlantic (18 per cent), believed that the necessary drive towards greater standardisation of ESG measurement terms, topics, factors and features should be left entirely to the sustainability reporting framework providers.

FIGURE #11: Do you anticipate participating in a drive towards greater standardisation of ESG measurement terms, KPIs, factors and features? *Please select up to two of the most likely/relevant to your organisation.*



SECTION 6

Patchy Benchmarking Capability

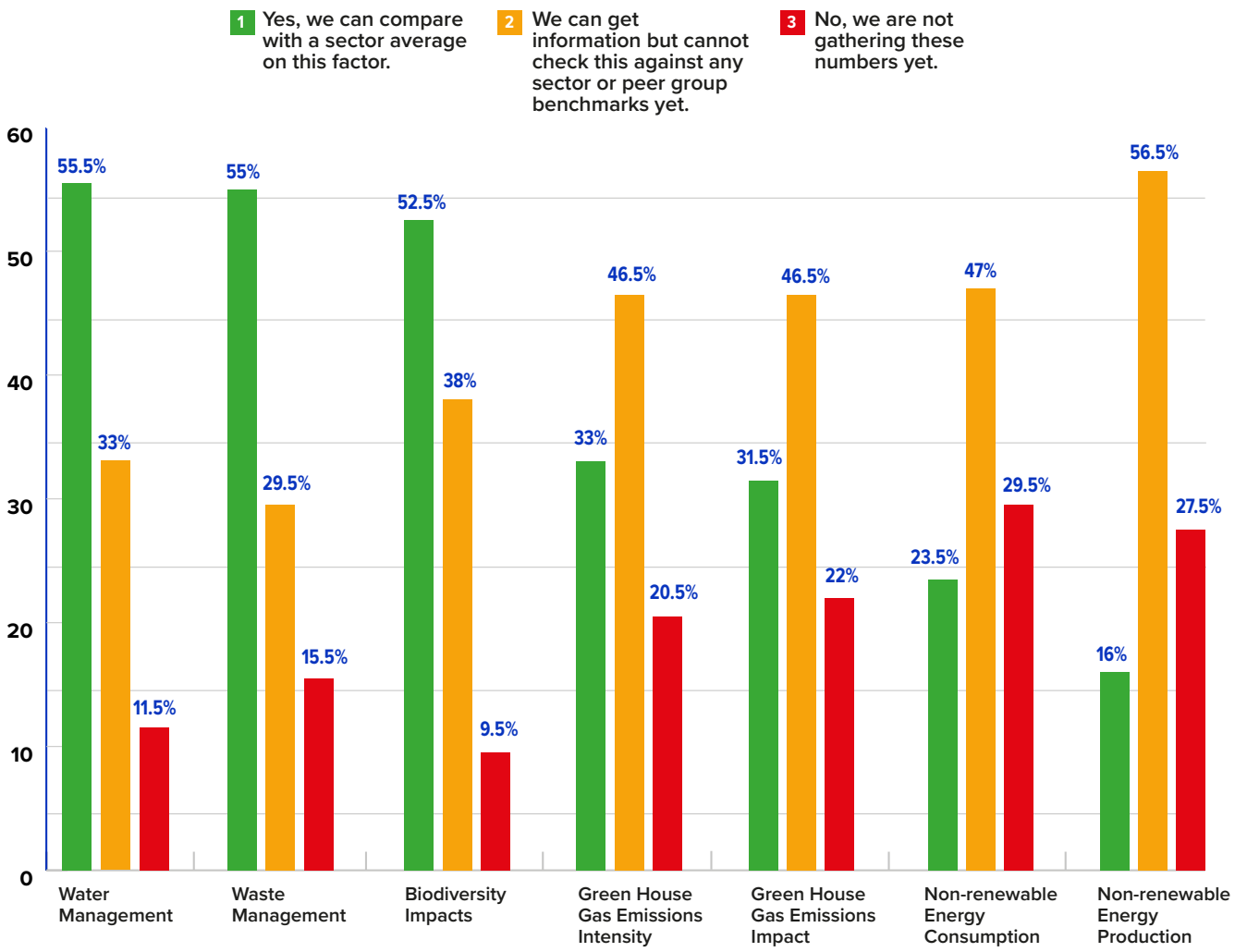
Environmental Reporting linked to key features like Greenhouse Gas (GHG) emissions intensity, water usage and waste management are being collected by most listed businesses today. However, asset owners and asset managers are increasingly facing more pressure to make sense of all the environmental performance data they are able to access. Ideally, they need to be able to benchmark the performance expectation of certain types of businesses – by sector or peer group and perhaps geographical region.

GaiaLens decided to look at specific environmental performance features to probe the extent of benchmarking capability amongst asset owners. We found that the capability of benchmarking corporates' environmental performance in this way was still limited to under four out of every 10 of the largest asset owners. Nearly one in every five weren't even accessing this key environmental performance data.

Across the below seven key environmental performance features or topic measures, we found an average of just over 38 per cent were able to gather the right data and compare it with a sector average or benchmark.

A higher percentage – 42.5 per cent across these same measures were not able to benchmark the environmental data which they had access to, against a sector or peer group average. Furthermore, an average of nearly one in five (19.4 per cent) of the largest asset owners were not even gathering or seeing this level of ESG performance granularity yet.

FIGURE #12: Do you have fully comparable figures for the companies you invest under the following Environmental reporting themes?



Social pillar data gaps revealed

This study also extended this investigation into the Social pillar to assess the level of data collection and benchmarking capability in this less easily measurable topic.

There were some Social features which more than half of largest asset owners on both sides of the Atlantic were collecting data for. Notably more than 53 per cent of asset owners were collecting data (on the companies they were investing in) on the Gender Pay Gap and 67 per cent were collecting data on community impacts.

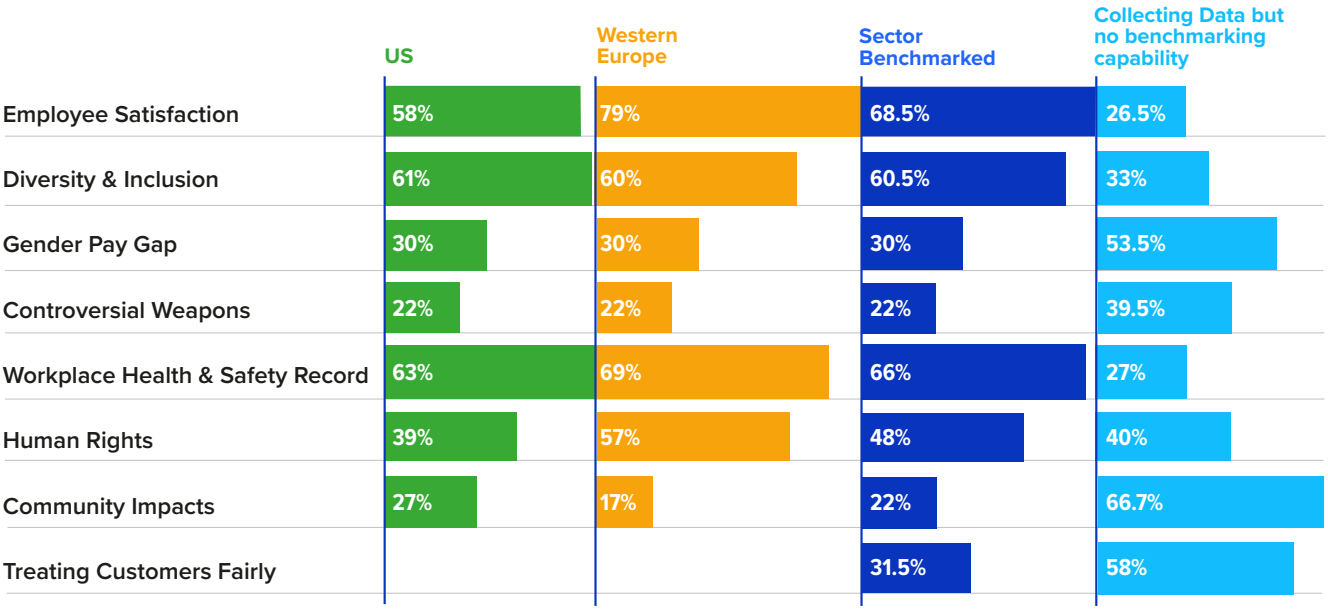
The survey also uncovered some positive signs that the majority of the largest asset owners had benchmarking capabilities in place in areas such as Employee Satisfaction and Diversity & Inclusion, where on average 68.5 per cent and 60.5 per cent respectively confirmed 'Yes, we can compare a selected company with a sector average on this factor'.

Interestingly, on the topic of employee satisfaction, amongst Western European-based asset owners a much higher percentage had this benchmarking capability at 79 per cent versus 58 per cent amongst US-based asset owners.

A higher percentage of Western European-based asset owners had benchmarking capability for the Human Rights record of companies they were investing in: 57 per cent of Western Europe-based asset owners had this capability versus 39 per cent of US-based asset owners.

By contrast, US-based asset owners seemed to be better geared to tracking the Community (Civil Society) Impacts of the companies they were investing in – 27 per cent of them had an ability to compare a selected company with a sector average on this factor amongst US asset owners, versus 17 per cent of Western Europe-based asset owners. More positively, and surprisingly given how hard it is to measure this, two thirds of all asset owners were able to access Community Impacts information - the highest percentage of all eight Social features which GaiaLens researched.

FIGURE #13: To what extent do you have fully comparable figures for the companies you invest under the following Social reporting features? *Please select one only for each line/feature.*



Gordon Tveito-Duncan, co-founder and head of ESG Technology at GaiaLens, commented:

"Our findings reveal that on key S & G performance measures as many as half of asset owners are not even collecting the right data yet or able to access it. However, worse in a way is the fact that on several key measures more than half of asset owners are unable to benchmark key S & G performance features against a peer group or sector average.

This is partly because not enough companies are making this data public. But the other issue is to do with the asset managers they often rely on for ESG performance ratings of the holdings they recommend.

Part of the problem is that the average asset owner maintains up to 180 asset managers across all its mandates. Furthermore, asset managers generally have different methods of reporting the ESG performance of individual holdings. So, aggregating all of that data and making sense of it is very difficult at asset owner-level."

Key Governance data collection reveals clear gaps

What does Good Governance look like? Many firms collect and disclose reasonably comprehensive governance performance data. However, asset owners again struggle to benchmark performance on a good number of the key features which together provide an objective assessment of good governance versus their sector or peer group. An average of 39.5 per cent of asset owners can sector benchmark against all eight core governance features.

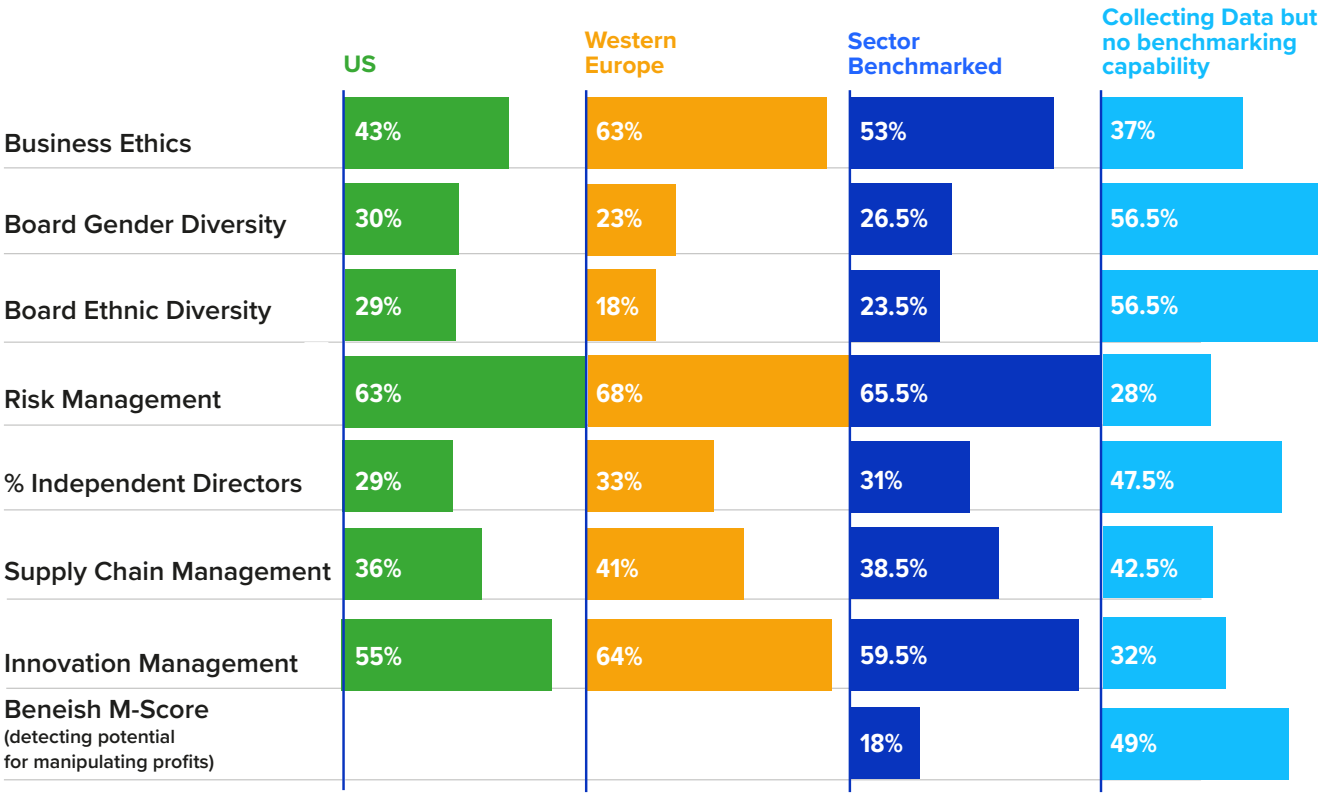
Western European asset owners leading US peers in most key Governance features

Western European asset owners leads their US-based peers in terms of their ability to benchmark governance performance of investments in most key features including Business Ethics (63 per cent of Western European asset owners versus 43 per cent able to benchmark performance in this area amongst US based asset owners); Risk Management (68 per cent versus 63 per cent in the US); percentage of independent directors available to the Board of Directors (33 per cent versus 29 per cent in the US); Supply Chain Management (41 per cent versus 36 per cent in the US); Innovation Management (64 per cent versus 55 per cent amongst US-based asset owners) and Beneish-M-Score benchmarking capability (19 per cent versus 15 per cent in the US).

US allocators leading on gender & ethnic diversity benchmarking

US-based asset owners were doing better in terms of ability to benchmark performance than Western European asset owners in two key (and highly topical) governance features: Board Ethnic Diversity (18 per cent in Western Europe versus 29 per cent amongst US asset owners) and Board Gender Diversity benchmarking (23 per cent amongst Western European asset owners versus 30 per cent of US allocators).

FIGURE #14:To what extent do you have fully comparable figures for the companies you invest in under the following Governance reporting features? *Please select 1 only for each feature.*



Turning ESG data into intelligence

Benchmarking capability is a function of maturity. First you gather as much information as you can lay your hands on, then you work out how this data compares with the data of an alternative investment and ideally the sector average.

Clearly some ESG features may lend themselves better to benchmarking than others. Some just may not be as useful to benchmark but are still relatively easy to collect data on. Attitudes to topics like diversity vary enormously according to where you are in the world.

It's difficult to know what is driving adoption of benchmarking capability precisely but clearly effective ESG measurement is key to managing poor performers out of portfolios. It is also key to targeting ESG pillars (and features within those pillars) which asset owners want to proactively move on from an Impact Investing perspective.

Link made between lack of ESG accuracy and greenwashing accusations

Despite the recent challenges which have been made to the drive towards ESG integration in some parts of the investment and banking world, it is clear from our research of asset owners that there is strong momentum and multiple drivers moving asset owners in the direction of iteratively improving the accuracy of ESG performance measurement prior to making new investments or portfolio adjustments.

Part of this drive for accuracy is also to avoid accusations of greenwashing – a risk which has travelled further up investment decision-makers' agendas following the DWS raid by the German police and the chief financial regulator in Germany BaFin earlier this year. This investigation is focused on DWS funds formerly labelled 'ESG integrated,' a term that referred to funds where ESG factors were analysed alongside other financially-material factors, but where managers retained discretion over ESG outcomes.

Over half (52 per cent) of asset owners which GaiaLens reached in January 2022, declared that they were investing in improving the accuracy of their ESG performance measurement (of the public companies which they were investing in) over the next 12 months.

Key drivers for improving ESG performance measurement in 2022

Key drivers for improving ESG performance measurement accuracy prior to investment in 2022 are, in order ('Top Priority' placement percentages only) :

1. Long-term they know that companies with strong ESG performance will deliver stronger financial performance – 49 per cent put this as their top priority reason for ESG measurement improvement in 2022.

2. To improve their ESG regulatory reporting – 47.5 per cent put this as top priority reason for ESG measurement improvement in 2022.

3. Help drive through our Diversity & Inclusion targets – 27 per cent put this as top priority reason for ESG measurement improvement in 2022.

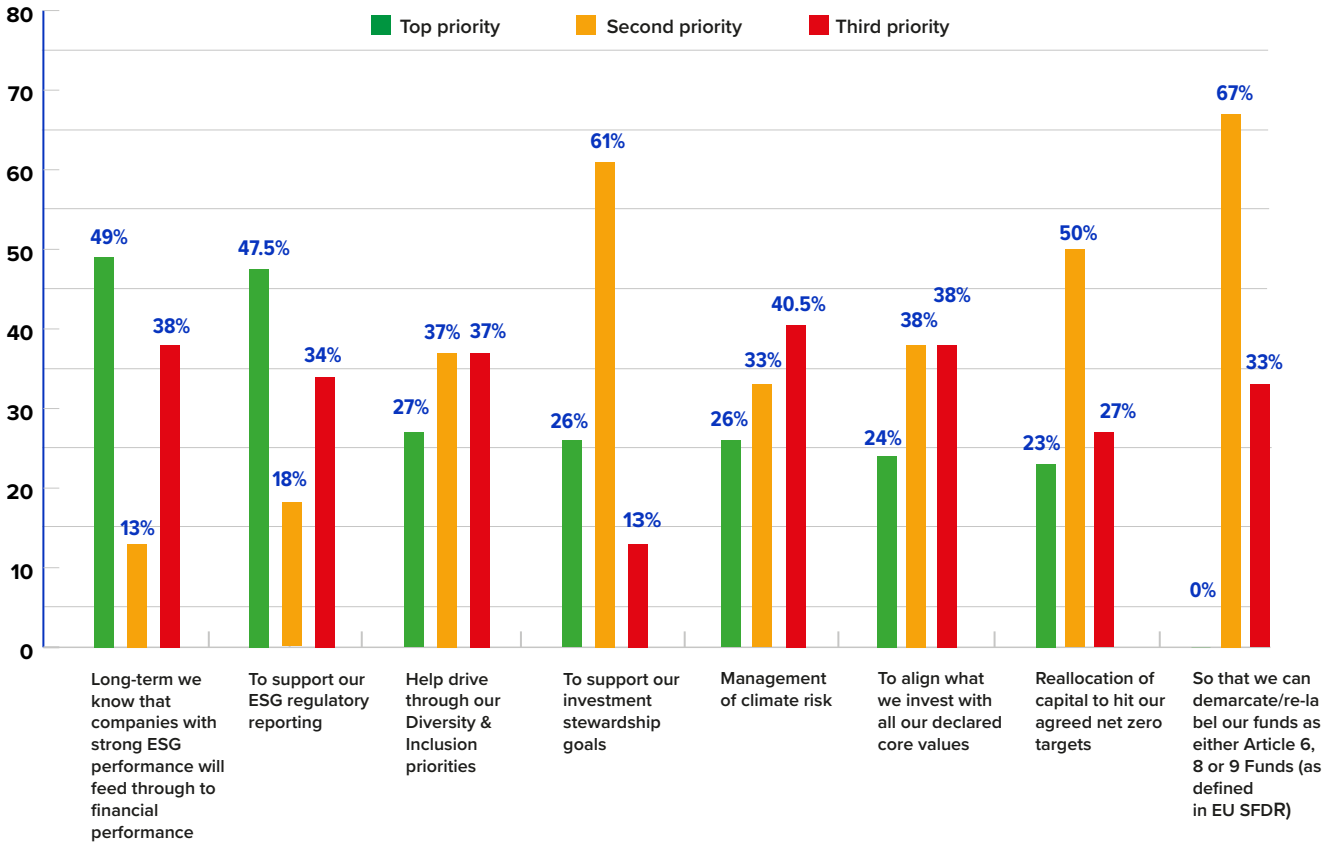
4. To support investment stewardship goals – 26 per cent put this as top priority reason for ESG measurement improvement.

5. Management of climate risk – 26 per cent put this as top priority reason for ESG measurement improvement.

6. To align what they invest in with all their declared core values – 24.5 per cent put this as top priority reason for ESG measurement improvement.

7. Reallocation of capital to hit their net zero targets – 23 per cent put this as top priority reason for ESG measurement improvement.

FIGURE #15: Why are you investing in improving the accuracy of your ESG performance measurement? *Please place the top three priorities in order of importance*



Carrot and stick

The drivers for getting ESG performance measurement right were many and various. However, chief among them (the top priority for 49 per cent of asset owners) was the belief that better ESG performance will translate into strong financial performance medium and long-term. So, it's in their investors' interests to move their money to companies delivering strong and/or continually improving and more detailed ESG scores.

That's the carrot and then for the stick: many institutional investors also recognise that tighter scrutiny of ESG disclosure is coming. This explains why very nearly half (47.5 per cent) of asset owners considered that improving ESG measurement accuracy was top priority for them in order to support their ESG regulatory reporting obligations.

DWS case will concentrate minds on avoiding measurement inaccuracy

Asset owners were also acutely aware that if they don't get ESG reporting right, the regulator and/or police and public prosecutor's office might, as is the case with the proceedings against one of the largest asset managers in Western Europe - DWS, bring criminal charges against the directors in charge, for prospectus fraud and other financial non-disclosure crimes. So, it's a reputational as well as a financial investment performance risk.

SECTION 7

COVID-19 and COP26 Impacts

Pandemic accelerated pace of ESG integration for over half of allocators

Because of the timing of the release of the questionnaire for this study in late 2021, GaiaLens decided to ask about the impact of both COVID-19 and outputs from COP26, on ESG integration decision-making up to that point some four months before movement restrictions were lifted in many parts of the US and Western Europe and just over a month after COP26 closed.

Over half (54 per cent) of the largest US and Western Europe-based asset owners which together are responsible for Assets Under Management of US$50.7 trillion confirmed that COVID-19 served to increase the pace of Environmental, Social and Governance (ESG) integration in their organizations.

Impact Investing gaining ground in pandemic

A slightly greater number (56 per cent) of asset owners agreed that the pandemic has brought the need for impact investing into sharper focus, as asset owners begin to make investment decisions with a view to generating measurable positive impacts on E, S and/or G pillar factors. Yet only 7.5 per cent of the largest allocators confirmed that they had fully deployed impact investing strategies to date.

Rise of D&I-led investing

Over a third (35 per cent) of asset owners have put a greater focus on Diversity and Inclusion performance generally during the pandemic, as the extended period exposed and exacerbated many social issues from inequality of incomes to racial tensions.

COVID-19 also seemed to be a period of deeper consideration of the existing and near future impact of climate change if big changes in where institutions place their assets are not made more urgently: nearly a third (31.5 per cent) of asset owners recorded that the last two years has seen a greater focus on climate change mitigation in their organizations.

COVID relief effort-linked investing proved to be more significant in the US

In the States, there was also a greater focus on shifting investments and resources to organizations which supported shorter-term COVID relief efforts – 28 per cent of US asset owners shifted some of their resources to meet this new requirement. In Western Europe that percentage shift was 18 per cent.

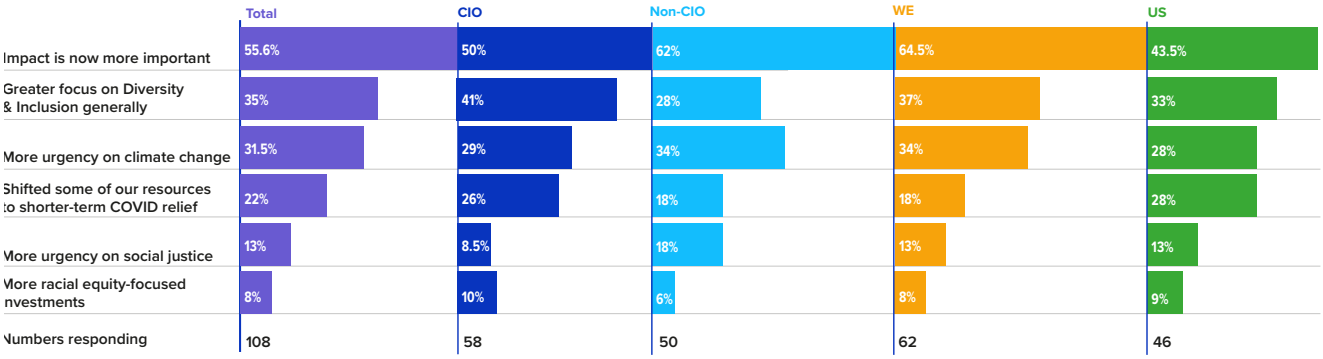
Allocators struggle to align investments with new ESG commitments

Yet despite the increase in focus on Diversity & Inclusion, just eight per cent of asset owners were able to migrate mandates to more racial equality-focused investments during the pandemic and only 13 per cent felt able to inject a greater urgency on affecting social justice changes. This might suggest that asset owners are struggling to identify specific social causes which they can address with investment changes.

Gordon Tveito-Duncan, co-founder and head of ESG Technology at GaiaLens, commented:

> *"Part of the problem here is that ESG has forced so many considerations on allocators at the same time. Prioritising what impacts they want to affect and then adjusting portfolios to bring them into line with their new sustainability goals takes time and is hampered by an absence of reliable data and uniform scoring systems for the data they can get hold of – that is where GaiaLens comes in of course."*

FIGURE #16: In what ways has COVID-19 impacted your company?
Please select all relevant.



COP26 also speeding up ESG integration projects

GaiaLens also probed any specific impacts which allocators most valued from outputs agreed at COP26, held in Glasgow in November 2021. The most significant output from COP26, for the largest asset owners which GaiaLens questioned, was 'the new requirements for asset managers to explain how they incorporate sustainability into their investment strategies (to allow consumers to make informed judgements about the kind of firms they want to invest in)'. 40 per cent of asset owners considered this development the 'highest impact' development from the climate summit.

Carbon credits pricing needs to rise significantly to reflect real cost to planet

Over a third (36 per cent) of asset owners thought 'greater clarity on the rules and modalities for international emissions trading should create increased demand for carbon credits, boosting market liquidity and potentially driving prices higher' was the highest impact change promised during COP26.

Many in the investment community now believe that the value of carbon credits must rise considerably to come closer to reflecting the real long-term cost of emissions to the Planet and all of us if we don't reduce them, at least in line with net zero targets being set by governments around the world.

Out of COP26 also came the founding of the International Sustainability Standards Board (ISSB), an independent body which develops and approves International Financial Reporting Standards (IFRS) that will offer global baseline sustainability reporting standards under robust governance and public oversight.

COP26 edges closer on global sustainability disclosure regime

To ensure that corporations and asset owners act to curb climate change, the COP26 conference also proposed standards for global sustainability disclosure to be regulated by the IFRS. The view taken was that financial markets need clearer, more comparable information about the impacts of unsustainable activity or investments, to encourage climate consciousness among asset owners.

Thirty per cent of the largest asset owners which GaiaLens, questioned just a month after COP26 ended, considered this of 'highest impact' in terms of developments being agreed at the climate change summit.

Nearly as many, 29 per cent, rated a new requirement that every investment product must set out the environmental impact of the activities it finances and justify clear sustainability claims of investments held inside those products, as a 'highest impact' change.

Increased investment product ESG disclosure requirements coming

To ensure consistency and transparency and to counteract greenwashing, new ESG information for a PRIIP (Packaged retail investment products and Insurance-based Investment Product) must be disclosed in KIDs (Key Information Documents), with reference to the EU taxonomy and SFDR requirements.

Another move toward robust governance is the European Union's Sustainable Finance Disclosure Regulation (SFDR) regulation, adopted in March 2021, which will assist institutional asset owners with comparing and monitoring the sustainability characteristics of investment funds.

SFDR establishes transparency requirements for financial market participants on the integration of sustainability risks and consideration of adverse sustainability impacts in their processes, and the disclosure of sustainability features of financial products. From a European perspective, it has already set out to change the status quo.

However, it is not all that easy when the baseline and underlying enabler of this measuring and monitoring of impact and disclosure is data. As has been an industry trend and pressure for many years; not all businesses have ready access to data, or indeed, the right data — especially small to medium institutions that may not have the resources or, more likely, the capital to enrich this side of their business model to improve their ESG goals or initiatives.

In the UK, HM Treasury said the new Sustainability Disclosure Requirements (SDR) mean an investment product will have to set out the environmental impact of the activities it finances. The SDR is set to go live in the UK during 2023.

These new environmental impact disclosure requirements will inevitably increase demand for more comprehensive and transparent ESG performance measurement for corporations, asset managers and asset owners alike.

Asset owners also thought that the climate summit's focus on finding a system to reflect real carbon prices more accurately in the market so that genuine cost to the Planet is measured more accurately for the purposes of carbon offsetting etc.

Key outputs from COP26 in order

The most significant outputs from COP26 in Glasgow for the largest asset owners around the world were, in order (Voted as 'Highest Impact') :

#1/40%: New requirements for asset managers to explain how they incorporate sustainability into their investment strategy (to allow consumers to make informed judgements about the kind of firms they want to invest in)

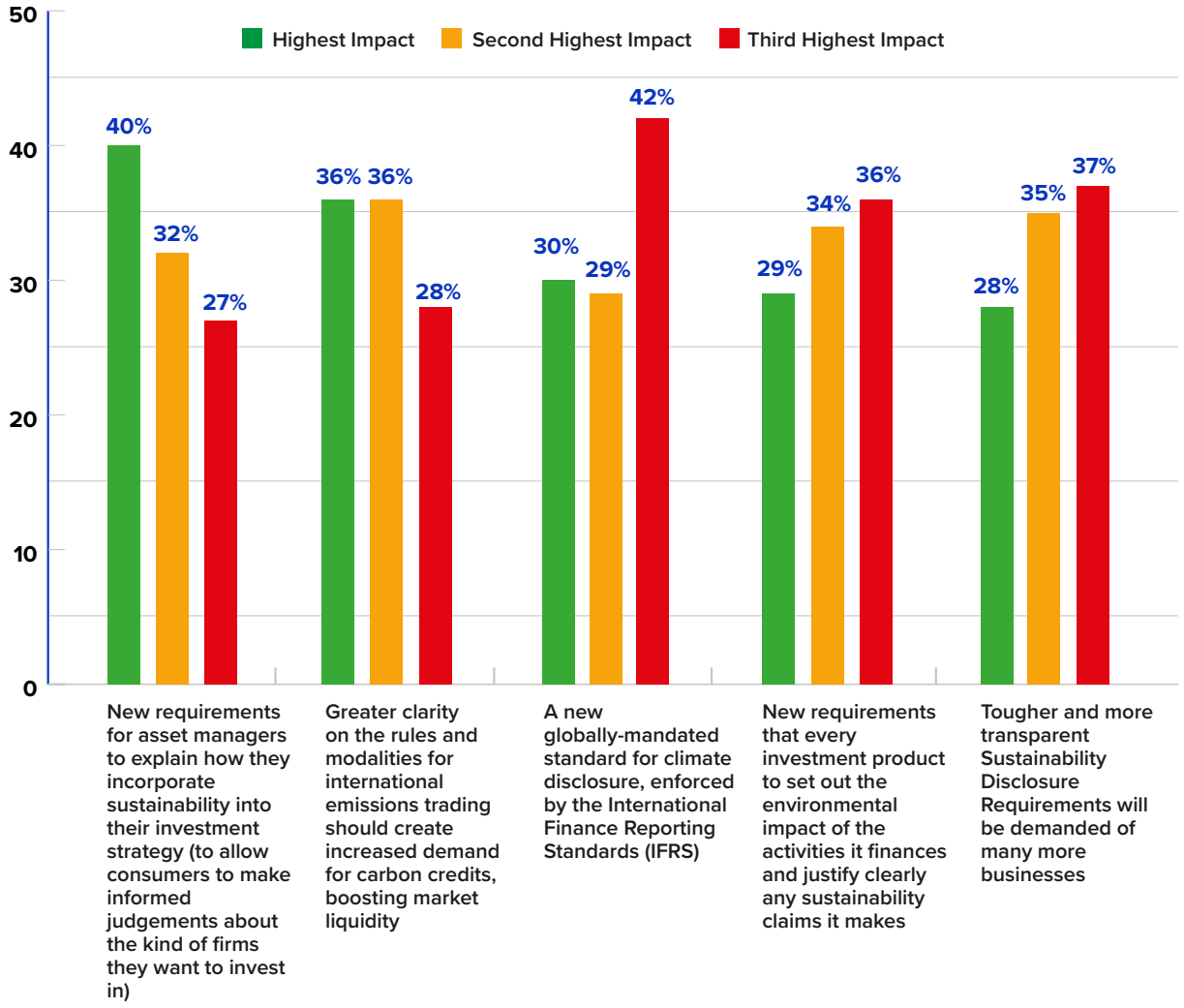
#2/36%: Greater clarity on the rules and modalities for international emissions trading should create increased demand for carbon credits, boosting market liquidity and potentially driving prices higher

#3/30%: A new globally-mandated standard for climate disclosure, enforced by the International Finance Reporting Standards (IFRS)

#4/29%: New requirements that every investment product to set out the environmental impact of the activities it finances and justify clearly any sustainability claims it makes.

#5/28%: Tougher and more transparent Sustainability Disclosure Requirements (SDR) will be demanded of many more businesses.

FIGURE #17: What changes do you see coming out of COP26 that will impact the importance of ESG scoring? *Please select your top three expectations to come out of COP26 in order.*



ESG data accuracy at the heart of better disclosure and dialogue

However, it's also clear that accurate ESG data is the key to moving ESG integration projects forward. It's critical to be able to see in near real-time when companies (that asset owners whose shares they are holding) are not living up to their own targets and global standards as they emerge.

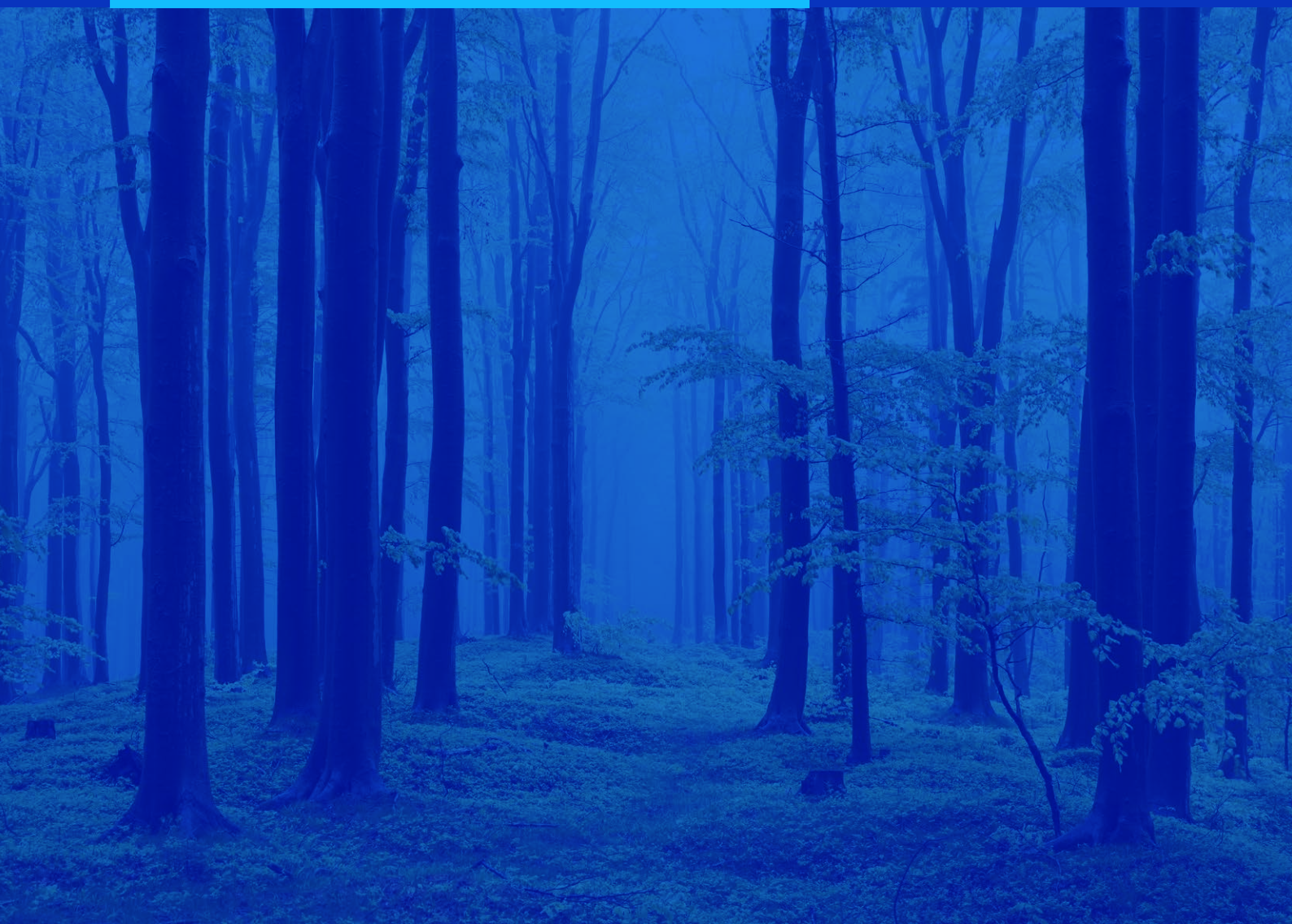
Once asset owners can access and benchmark this data, they then need to form their own independent assessment of their portfolio exposure to climate risks and use it to push for a robust dialogue with their asset managers on how they are managing these risks across companies and issuers.

Gordon Tveito-Duncan of GaiaLens added

> *"If COP26 taught us anything it was that we need to move towards more robust ESG strategies with greater speed. The first step is about building the right data and systems for analysing, scoring and benchmarking that data so that it's meaningful and can be used to inform sound investment decisions which protect the planet and is inhabitants longer term, as well as preventing investors from losing out. Asset owners must ensure they have the data available to integrate the discussion of E,S and G impact into their business strategies."*

SECTION 8

Summary



This study finds asset owners in the midst of very significant change to ensure that the investments they hold (on behalf of their stakeholders) reflect ESG targets and values which many have now begun to articulate.

The next challenge is to get into dialogue with what is often hundreds of their contracted asset managers to make sure the mandates they give them are measured by the same targets and provide comparable and ideally benchmarked ESG scores for their portfolios. Ultimately, it is going to be crucial for asset owners to find a universal system of measurement and reporting on ESG performance regardless of who manages the mandates.

Systems will also need to be built to flag up alerts if specific portfolios and holdings show signs of straying from agreed ESG targets and corporates' declared ambitions. These systems will in the end need to be highly agile, absorbing negative as well as positive, new data points as they emerge. Greenwashing, or indeed ESG-washing by the largest asset managers and allocators will become increasingly unacceptable. And as regulators tighten up their stances on 'ESG-washing', we will start to see more criminal prosecutions line the one which DWS is currently subject to.

Without an ability to monitor ESG scores against relevant indices, it is going to remain very difficult to manage portfolio adjustments in an orderly way which does not reduce returns significantly. The fact that one third of US-based asset owner senior decision-makers were still thinking ESG integration was negatively impacting returns at the start of 2022 reveals how far we still need to travel.

The jungle of differing ESG reporting frameworks will also need to be consolidated as a handful of clear winners, as identified in this research, strengthen their offerings and accommodate nuances – allowing for customisations which asset owners in different territories require.

ESG data will be the lubricant for all of this measurement which will enable institutional money to move inexorably in the direction of investments which consider the planet and its inhabitants holistically – going beyond reducing global warming through carbon emissions reductions as we drive towards Net Zero Carbon; to underwriting the product, service and lifestyle changes which will need to be made rapidly to reduce current demands for all finite resources of the Earth, while also supporting the health and wellbeing of us all. Economic growth and prosperity should still be possible even as we are making all these changes for the long-term good of us all.

The trick will be to ensure new data sets offer genuinely new insights and intelligence, which asset owners and asset managers will be able to put to work as they fine-tune increasingly robust ESG performance measurement systems.

Finally, asset owners must do all of this for E, S and the G as the financial world recognises the importance of making changes to create a fairer, more equal, just society and communities, not simply one with a more stable climate.

GaiaLens commissioned US-based investment market specialist market research agency Beresford Research to complete this CATI (Computer Assisted Telephone Interviewing) study which gained responses from 200 of the largest asset owners. One hundred of these respondents were based in the US and a further 100 from Western Europe including the UK.

28 per cent of the sample held assets under management (AUM) of US$500 billion or more; 22 per cent had AUM of US$250 to 499 billion, 26.5 per cent had AUM of US$100 to 249 billion and 23.5 per cent had US$10-99 billion. Together the 200 asset owners questioned for this survey represent AUM of US$50.7 trillion. 50.5 per cent were investing on behalf of Corporates; 30.5 per cent for Pension Schemes; 10.5 per cent for Public/government schemes; 3.5 per cent for Endowments and 3 per cent for Foundations.

Analysis of respondents' job titles revealed that 52.5 per cent were Chief Investment Officers (CIOs), 24 per cent were Heads of Sustainability and 23.5 per cent were Heads of ESG Integration. All respondents confirmed that their organizations had 'incorporated ESG factors into your investment decision-making processes.' Respondents completed 26 question survey questionnaires between 7th December 2021 and 10th January 2022.

Thank you for reading our inaugural report

GaiaLens was formed to help asset owners and asset managers alike to accurately measure and benchmark the ESG performance of individual holdings and portfolios. We exist to provide this accurate measurement with a view and to stimulate public companies to improve all key ESG metrics - giving institutional investors the wherewithal to push companies they are investing in to make identifiable, positive ESG improvements. Our systems enable institutional investors to flag ESG features where companies are performing poorly relative to their peers, their sector or index.

GaiaLens focuses on ensuring unstructured as well as data sources are tapped into in real-time, probing any juxtaposition between what public companies are saying about their ESG performance improvements and what is actually being reported by the law courts, traditional and social media, respected NGOs and independent online review sites. In this way, it's possible to uncover evidence of greenwashing (and 'ESG washing' as a whole) rapidly and to use this 'early warning' intelligence to diversify out of specific public companies which are not 'walking the ESG talk'.

Our ESG performance reports are proving to be a powerful engagement and education tool - enabling asset owners and investment managers to spot areas where increased disclosure is needed by the companies that they remain invested in.

The findings in this report confirm the value of turning growing amounts of ESG data into actionable intelligence which protects investment growth, as well as helping market participants to hit and even exceed ESG performance targets.

If you find any of the findings in this management report interesting and you would like to explore how to address some of the challenges highlighted here, please do get in touch at seb.kirk@gaia-lens.com.

Seb Kirk
CEO & Co-founder
GaiaLens

About GaiaLens' ESG analytics platform

GaiaLens is a data-driven, real-time environmental, social and governance (ESG) platform designed to help asset owners, asset managers and pension trustees to fill ESG data gaps and test the self-certified ESG claims of publicly listed businesses. Founder, Gordon Tveito-Duncan believes that "You cannot change what you cannot measure", his platform now enables any corporations or asset managers to quantitatively measure ESG performance and therefore act on any areas of which are not upholding the pillars.

Using artificial intelligence and machine learning, GaiaLens offers a clear visualisation of a company's performance in environmental, social and governance areas, making it easier for corporations to recognise and act if they were underachieving.

Most recently, GaiaLens launched a new ESG news service to help investors track ESG incidents and gather the latest available company data. GaiaLens Momentum processes news coverage related to public companies wherever it appears across thousands of traditional and trade news sources. Tweets from over 100 ESG thought leaders are instantaneously analysed to see if any companies are mentioned. Clients can upload a portfolio, then the ESG Incidents data feed will show them if there are any emerging ESG events that are relevant to the portfolio companies.

For further information about GaiaLens, please contact:

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