Future First[SM] *Insights*

A Data-Driven Approach to Responsible Investment

By Corinne Neale and Gerald Rehn

BNY MELLON
Consider Everything

Institutional investors are increasingly defining custom environmental, social and governance (ESG) goals. A 2021 survey of BNY Mellon clients, representing asset managers, asset owners, alternative asset managers, banks, broker-dealers and insurance firms, found that 63% of respondents would conduct or continue to conduct sustainability-themed or impact investing over the medium term. That number increases to 69% among asset owners specifically, including central banks, pensions and sovereign wealth funds.[1] This represents an evolution to a proactive approach, compared to a historical approach to ESG investing that focused more on excluding particular companies or industries, and additional research indicates that this percentage is likely to increase.[2]

This growing trend is creating demand for sufficiently accurate data to measure themes and impact. Although there are many data methodologies and metrics, there is still no universally accepted source for investors to use. So, do they have the right data to support their investment decisions?

Addressing this question requires understanding:

- What ESG themes and impacts matter most to investors
- How investors make use of the data available to them and whether it is sufficient to their needs
- How investment outcomes in conjunction with ESG goals can influence their decision process

[1] BNY Mellon, "The Race to Harness ESG and Sustainability"

[2] FTSE Russell, "Asset owners are buying into sustainable investment"

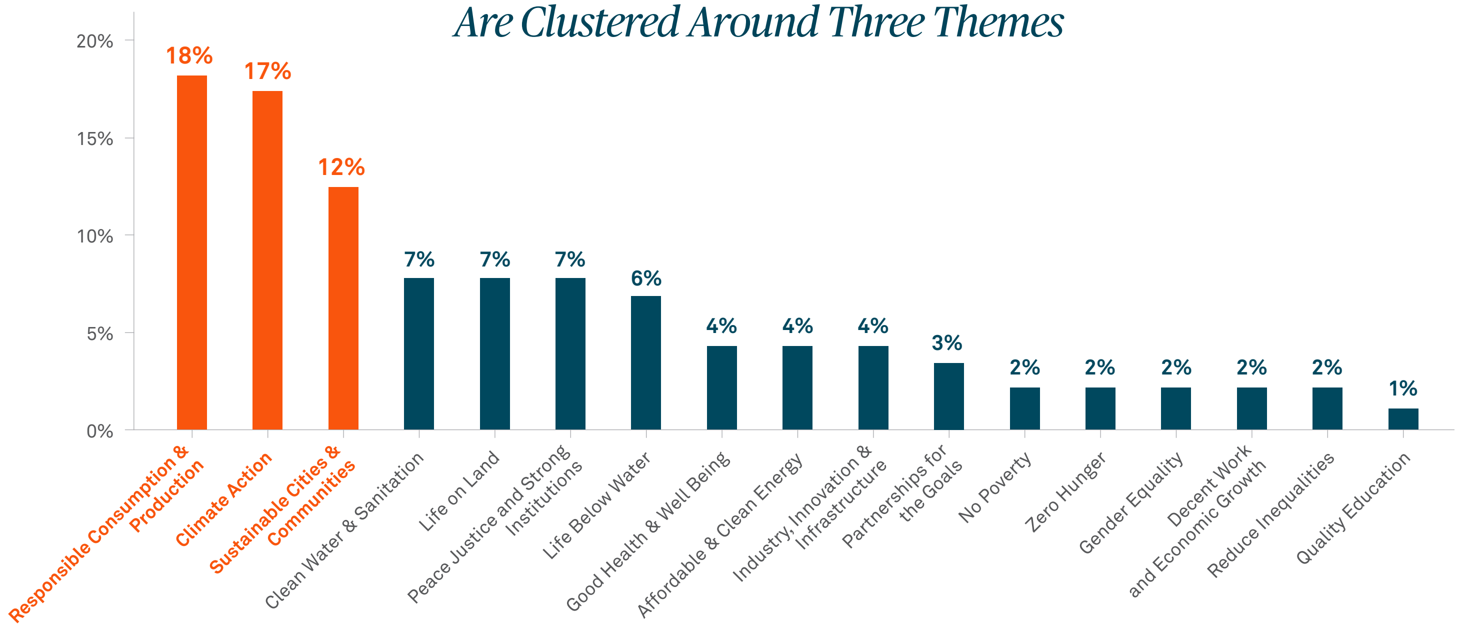
What Matters to Investors?

BNY Mellon analyzed a range of more than 2,000 responsibly focused investment goal selections, spanning institutional investors in North America (44%), EMEA/UK (43%) and Asia (13%), and representing an equal number of asset owners and asset managers. The data was drawn from the crowd-sourced metrics collected from BNY Mellon ESG Data Analytics subscribers[3] between July 2020 and July 2021.

We mapped these goal selections to the 17 United Nations Sustainable Development Goals (SDGs) and found that nearly half fell into just three categories (see Figure 1):

- Responsible Consumption and Production (18%)
- Climate Action (17%)
- Sustainable Cities & Communities (12%)

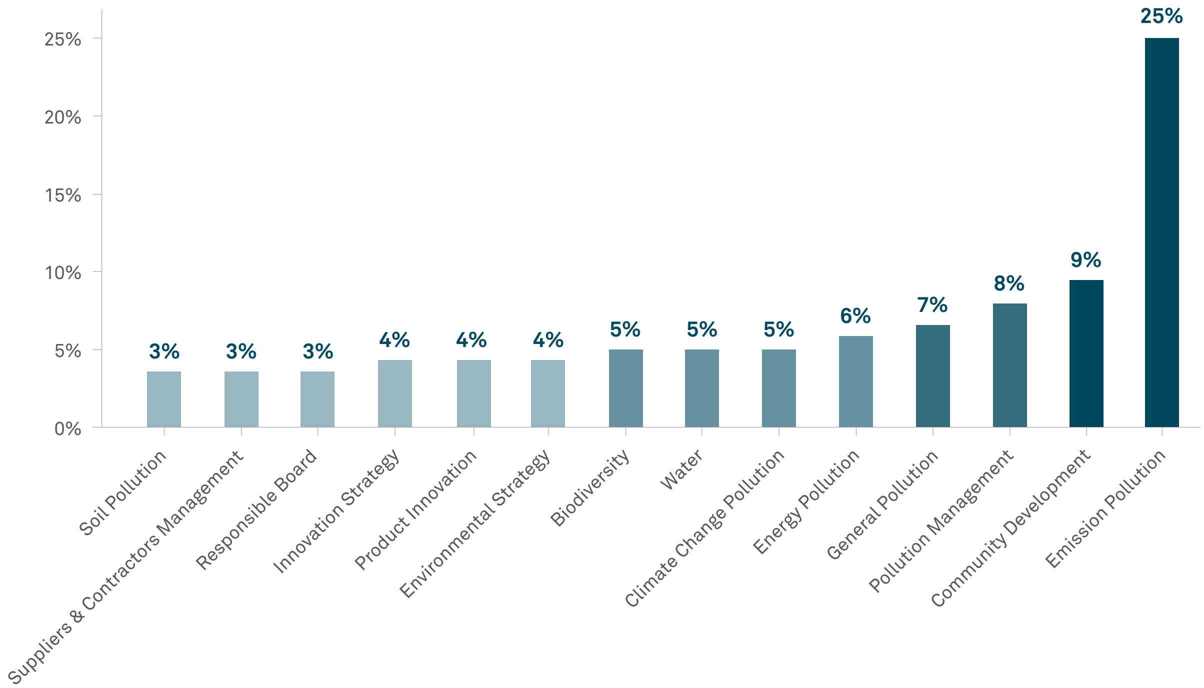
Figure 1: *Nearly Half of Responsible Investment Goals Are Clustered Around Three Themes*



[3] BNY Mellon ESG Data Analytics is a cloud-based application that enables investors to extract value from data to meet specific needs from investment policy development and portfolio management to monitoring and reporting.

This exercise, by providing a better understanding of investors' goals, gave us a clear indication of the data of greatest relevance to them. Since these are such broad categories, however, we then did a second round of analysis, applying natural language processing to the thousands of factors within the ESG Data Analytics application, to zero in on more specific underlying ESG factors identified as goals, normalized across all data sources.[4] This identified investors' top 14 selected ESG factor goals (see Figure 2).

Figure 2: *Investors' Top 14 Factor Goals Cover E, S and G Categories*



The question we needed to answer, at that point, was: Do investors believe that there is sufficient data available to support these 14 factor goals? With ESG Data Analytics, investors have the option to track and provide feedback on whether individual data points meet their goals. Investors can vote in one of three ways:

1. **Vote to accept a factor** and use it for investment portfolio construction and monitoring.
2. **Vote to ignore a factor,** keeping track that they reviewed it but decided against using it.
3. **Vote to reject a factor** if, in the investor's view, the factor does not meet their expectations.

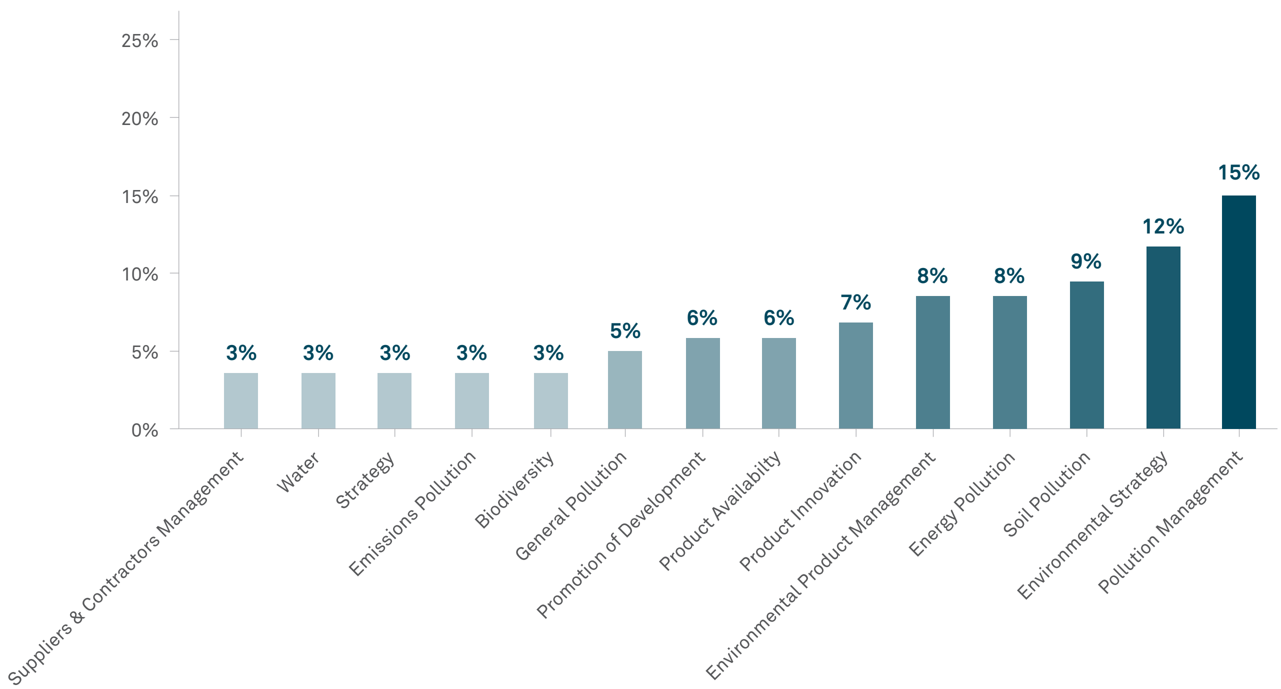
This functionality forms a virtual feedback loop: Other investors can see what data their peers found useful; data providers can understand where investors have requested enhancements; and investment product manufacturers gain insight on the goals that investors have prioritized.

[4] The sources used to support investors' chosen themes came from a wide range of public, vendor and proprietary sources.

Across all data used in ESG Data Analytics between July 2020 and July 2021, 14% of the factors were rejected or ignored by investors while 86% were accepted. While this may be considered an acceptable balance, it needs to be noted that 68% of the factors rejected or ignored aligned to the 14 most selected factor goals in Figure 2. This means that most of the data for the top 14 factor goals was considered unfit for purpose.

While it can be expected that the most selected data will also be the most scrutinized, this indicates investors think the data they most need does not completely meet their goals. The breakdown of rejected and ignored data amongst the top 14 selected factors are represented in Figure 3.

Figure 3: *Rejected and Ignored Factors Amongst the Top 14 Selected*



Double Materiality and Greater Transparency

While investors need appropriate data to understand how investments align to their ESG goals, they also need data to help them understand how the inclusion of ESG factors in their portfolios can impact their investment performance. The concept of "double materiality" is often used to describe investors' desire to balance financial and non-financial outcomes. Not only does it measure the impact of ESG on a company's performance, but also the company's impact on the broader world.

BNY Mellon uses two types of impact metrics: SASB financial materiality screening in investor-led sustainability factors or themes selection, and financial performance contribution from investor-led sustainability factors. SASB Standards guide the disclosure of financially material sustainability information by companies to their investors.[5]

> According to the Non-Financial Reporting Directive, a company is required to disclose information on environmental, social and employee matters, respect for human rights, and bribery and corruption, to the extent that such information is necessary for an understanding of the company's development, performance, position and impact of its activities. Climate-related information can be considered to fall into the category of environmental matters.
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> European Commission, Guidelines on non-financial reporting: Supplement on reporting climate-related information, June 2019, last accessed October 27, 2021, p. 6.

[5] SASB, "About Us," last accessed October 27, 2021

While double materiality is compelling in theory, it is difficult to measure and report accurately. Data limitations, differing individual client preferences on which factors to use and the varying weights of such financial and non-financial outcomes, all add potential complexity, making it difficult to accurately compare companies in portfolios.

Therefore, transparency in data points that are relevant for investor decisions is critical, and the quality of data is more important than quantity. For example, SASB Standards provide a more specific set of metrics to guide decision-making. In addition, investors will typically prefer to focus on their priorities. Proprietary ratings can add further nuance by giving investors a chance to remove noise from their various holdings with multiple managers.

Clear Goals, Clear Outcomes

Matching full transparency of portfolio goals and holdings with diversified and verified data sources ultimately creates best-in-class reporting for responsible investments. We believe the minimum elements of such reporting include:

1. Clear descriptions of the objective(s) of the portfolio so that investors have sufficient information on what they are buying and the portfolio's aims, thereby achieving appropriate product suitability to match their objectives
2. A range of ESG data points including:
   - an overview of ESG metrics on the portfolio;
   - E, S and/or G benchmarking versus index/indices; and
   - coverage of ESG data as % of portfolio
3. Disclosure of holdings in the portfolio, including details of E, S and G standout ratings (both good and bad) on individual securities for equity funds and identification of green, social or sustainable bonds as %'s of the portfolio for bond funds
4. Details on stewardship, the portfolio's desired outcomes and achievements (e.g., publishing actions taken to align to responsible priorities, voting records and goals for engagement and proxy voting).

Data Quality Still Poses Challenges

Recent industry surveys have commented on the gaps, deficiencies, and even outright absence of ESG data. For example, a survey published by the Index Industry Association in July 2021 found 63% of asset managers surveyed in the US and EMEA named the lack of reliable ESG data as a major or moderate inhibition to making investment decisions.[6] Metrics from BNY Mellon ESG Data Analytics confirm that given the choice, investors consistently select factors with better completeness, depth, materiality and recency for investment selection and oversight.

In summary, investor acceptance of ESG factors suggests that data on the most popular factors selected are not universally considered to be fit for purpose. But we believe data is on the verge of improving, with investors finding and using more outcome-oriented data. The current proliferation in data requests in both volumes and types confirms that institutional investors are using more data sources to cross-reference their views, validate the data at hand and assess the outcome of their decisions.

Moreover, such demand is driving significant data innovation as data management capabilities evolve and as standards further solidify. We believe investors who stay at the forefront of these data improvement trends will be rewarded with better data and tools as they continue to pursue their responsible investment goals.

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[6] http://www.indexindustry.org/esg-survey/

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