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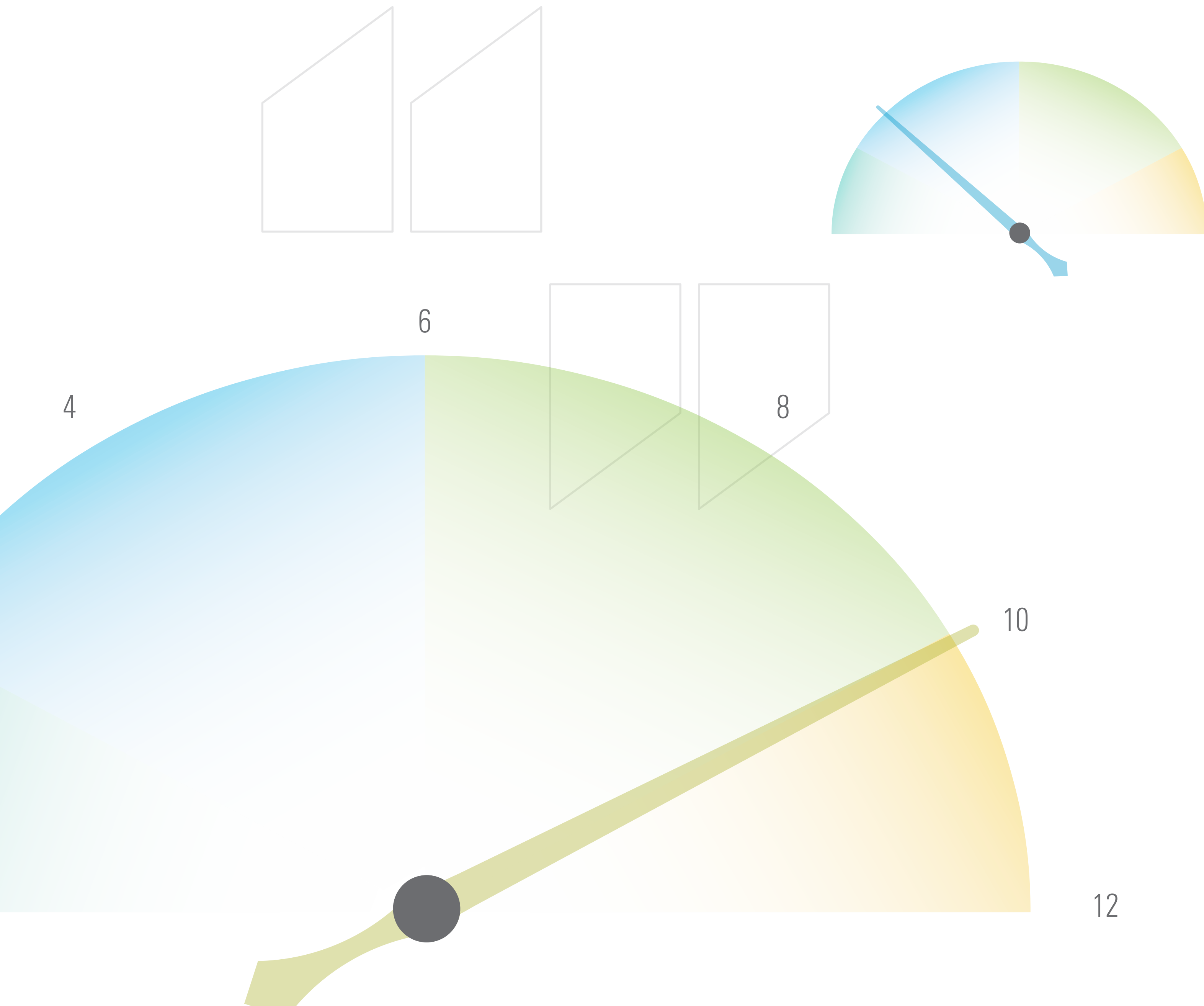
Voice of the Asset Owner Survey

Conducted by Morningstar Indexes and Morningstar Sustainalytics



A Global Survey of Institutional Investors' Priorities and Perspectives

Introduction

As stewards of capital, institutional asset owners (AOs) play an incredibly important role in the global market ecosystem. Acting as fiduciaries, AOs oversee some of the world's largest pools of invested capital and direct investment policy on behalf of pension plans, foundations and endowments.

To better understand their motivations, challenges, and attitudes in the current environment, Morningstar, through its Indexes & Sustainalytics teams, have embarked on a global multi-phase survey with assistance from Collie ESG. Topics being explored include:

- Investment objectives and policies
- Perspectives on current and future investment trends
- Impact of regulatory change
- Key stakeholders and influencers
- The role of ESG in investment decisions
- Opinions on ESG data and service providers

Phase 1 - Qualitative Insights

During the first phase of our study, we spent most of March 2022 conducting in-depth qualitative interviews with 14 leading AOs—5 in North America and 9 in Europe. Insights gained from this phase will inform a broader, quantitative study covering a much larger sample of AOs later this year. Our initial findings are summarized in this report.

Although global AOs share a common investment context, they represent diverse constituencies and objectives, with a range of priorities.

The global investment community is diverse, with each AO's perspective, approach, and measure of success shaped by several factors: different stakeholders; different regulation; different history; different norms; and different cash flows. There are, however, several common threads:

Asset owners face a strong undercurrent of change.

What they do have in common is the global market environment in which they are operating. And while this environment is always subject to change, the number of major market drivers is especially high in 2022. From Covid to Russia's invasion of Ukraine, to the limitations of globalization and the morphing of inflation from vague threat to stark reality, there is an unusually long list of fundamental challenges for investors of all types.

> "We are actually astonished at the links between the Russian economy… it is because there are so many things that are interconnected."

At the same time, there is an ongoing structural realignment of pensions systems occurring around the world (notably at present in the Netherlands, US, UK, and Australia). The impacts of increasing pension plan maturity, consolidation, and regulatory change – including significant ESG-related regulatory activity – were notable in our conversations.

> "The precipitous decline in equity allocations among private sector plans."

> "All Dutch investors are quite busy with the new pension system, to get ready for that."

AOs continue to evolve their strategies and are increasingly dependent on strategic partnerships with key providers.

Diversification into illiquids and a wide range of alternative assets is a well-established trend among global AOs. The reliance on fixed strategic allocations continues to decline, as they explore ways to manage the ground between traditional strategic asset allocation and day-to-day stock picking.

Meanwhile, many asset owners are resource-constrained, relying heavily on key providers as strategic partners for data and market insights, and as a general sounding board.

ESG is increasingly embedded into mainstream investment processes.

The AOs we spoke to see ESG as a core element of investing rather than a specialist niche. In other words, the view is that ESG has fully transitioned from a "nice to have" to a "must have." One side-effect of an increased focus on ESG factors is a lengthening of time horizons.

> "If you go back 5 or 6 years, ESG wasn't part of mainstream investment. That was a problem."

We also heard that ESG is driven both by client demand and by investment conviction. The mandate for consideration of ESG factors has been strengthened by wider public awareness and support. Regulation that endorses AOs taking a broader view of their responsibilities has also been influential. This is especially true in Europe, which sees itself as ahead of the rest in this regard.

> "It has been their concern for a longer time, but I think during Covid it accelerated"

> "Before, it was globalization, efficiency. Now, it is more emphasis on resiliency than efficiency".

Performance, materiality and risk are key topics for AOs.

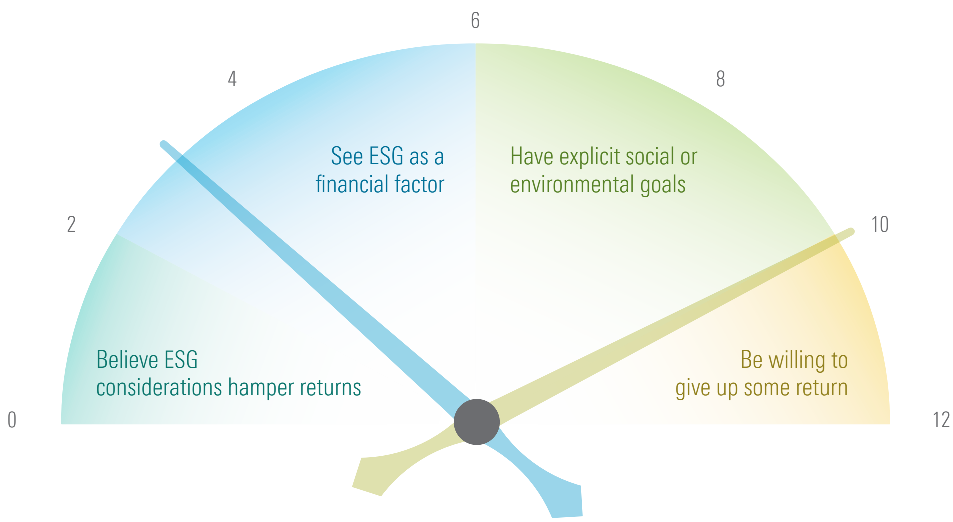
AOs implement ESG factors both to enhance their investment process and to recognize their broader impact. They see themselves as both impacting – and being impacted by – the imperative of sustainable development. Most respondents consider ESG objectives as valid goals when pursued alongside (but not at the expense of) financial objectives.

> "The tag line 'Investing for a world worth living in.' So it's about making those positive returns, but also having a positive impact on society."

> "My foremost important fiduciary duty is to outgrow the liabilities."

When asked to place their organizations on the ESG spectrum below, respondents fell into the range between 3 and 10, with most at 6 or above, and several at 10. This implies that ESG factors are seen as desirable objectives when used in a tiebreaker context. Those who placed themselves below 6 tended to cite fiduciary concerns as the reason. This group felt that ESG factors should be considered in investment decisions only where there are financial grounds for doing so.

ESG spectrum



Source: Collie ESG

> "We do see ESG as a financial factor, but we don't see it as purely a financial factor."

> "We cannot go to pensioners and say 'Oh well, your pension's going to be reduced, because we decided we needed to save the planet.' That is not happening."

There is a broad agreement among respondents that ESG does not harm investment returns.

> "Our investment beliefs are that ESG doesn't hamper returns, and in the long term will improve the return over risk."

Progress is being made to improve ESG data and tools, but much more is needed.

There are clear signs of emerging best practices in many areas. Better measurement requires development of both quantitative tools and qualitative understanding. Many AOs are looking for simpler, more standardized measurement. Others – typically the larger, better-resourced organizations – are asking for improved transparency into the underlying data. This is a key area of development, but a complex one.

> "We need dashboards, we need specialization. We just need these tools to be ready made cookie cutter."

> "More demand also just for raw, granular ESG data… so then people can combine it, use it how they please."

> "SFDR will push transparency, it will push people to ask critical questions of companies, of investors, of banks, you name it. But I don't think the data issue will be solved."

Low correlations between the ratings of different ESG data providers reflects a trade-off between the benefits of standardization and the value of independent thought. Data challenges are substantial: it is no small task to source consistent, meaningful, up-to-date data across a broad range of ESG factors.

> "I do think we need a better understanding as investors, how we need to integrate the S part in the whole story."

> "One of the things we struggle with is we've got the data sources and they each have their own platforms and we need to get it on a centralized system."

> "If you steer your investment based on estimations which are not verified and maybe easy to manipulate, what does it mean for your investments?"

ESG is developing and maturing – but still messy.

Although the ESG investment space is maturing, it is a complex field. In many ways, it is frontier territory and difficult to pin down. ESG issues such as climate are what social scientists refer to as "wicked problems," in that they are complex and hard to isolate from other issues, with no clear definition of success.

Precise objectives are, accordingly, hard to define. Assumptions can differ, and terminology is inconsistent and often confusing. Issues such as climate, biodiversity, land use and ocean health are non-linear and closely interconnected. The answer to too many questions is, "it depends".

> "It's quite hard for a pension fund board to have the overview of everything that's being required, everything that's possible and all the implications it will have. So the vastness of the area, it's a challenge."

Climate is the biggest concern, but there is much more to ESG than that.
As would probably be expected, climate was the dominant environmental consideration that was mentioned. Some observed that the attention on climate could have the effect of crowding out other topics.

> "Climate has definitely risen up the agenda."

> "A number of clients have declared a climate emergency."

There were also several mentions of other areas of significant focus, most notably biodiversity. Even compared to climate, the tools for measuring, analysing, and addressing biodiversity issues are in the early stages and require significant development.

> "Biodiversity, something needs to be done. But the question is how one does that."

> "Biodiversity is becoming a huge topic, we see it as climate 2.0 but I'm not aware of good biodiversity indicators."

Among social factors, diversity, equity, and inclusion were the most-mentioned topics. Social focus tended to be more closely reflective of the nature of the organization than environmental.

> "If a manager comes to me [that is] completely male-dominated and non-diversified at all, I have control, I can say 'I don't want you'. So it can actually make an impact."

> "As far as other themes go, human rights is a big one, specifically within that human trafficking and forced labor."

With asset management organizations faced with the temptations of box-ticking and greenwashing, asset owners want authenticity.
Greenwashing, and in some cases, "greenwishing" (well-intentioned but ineffective activity) is a concern for many AOs. ESG has a higher profile within many large asset management organizations and is increasingly driven by regulatory demands. This makes it difficult for AOs to test the authenticity of its integration into investment processes. Increasing investor knowledge, experience, and familiarity is needed to distinguish the genuine from the superficial.

> "I've noticed that some asset managers have brought on just a bunch of young staff as ESG analysts, but there's not much institutional knowledge there."

> "You need to walk the walk, rather than have the badge."

Asset owners are ramping up their stewardship and engagement efforts.

The role of stewardship within ESG is gaining greater attention and is seen by many as offering significant scope both for better financial outcomes and for more positive broader impact. Groups such as PRI, Climate Action 100+, and the IIGCC are viewed as a valuable resource for improving the effectiveness of stewardship efforts. AOs are using industry organizations to leverage resources alongside participation in public policy forums.

> "In being vocal about what we do, we're setting standards and we influence indirectly a broad group of stakeholders."

> "Given that our team is relatively small, we do need to choose wisely, what really brings added value, and what can help us, and also where we can contribute in a meaningful way."

Screening and divestment are practiced by some AOs, but are generally seen as marginal tactics. Instead, AOs are looking for their asset managers to engage directly with companies, motivated both by the desire to improve financial outcomes and the desire to more directly manage the environmental and social impact of their activities.

> "We have several exclusion policies on fossil fuels, tobacco industry, controversial weapons, and we're also mindful about controversies with a high risk of reputation or financial or legal concern."

> "We had the discussion on engagement versus exclusion and at that point we said we want to incentivize, to push companies to decrease CO_2 emissions. So we'll go for engagement and not for exclusions."

> "It's not just blah blah at the Board level, it's actually policies… that the culture reflects those policies is very, very important. And that also is linked to ESG performance in a very significant way."

Conclusion and next steps:

The qualitative phase of our first Voice of the Asset Owner Survey revealed some not-so-surprising results. It also surfaced areas that warrant further investigation, which we plan to explore during the second phase of our study.

We heard almost unanimously from the AOs we interviewed that ESG is a critical part of their investment policy and day-to-day thinking. They know it is a very important topic, but they are not always sure how to address it. ESG is a "wicked problem" they are trying to work through.

Regulation is certainly a challenge and, while AOs stress that ESG data and tools are improving, they are not shy about stressing that providers of these data and tools have much more work to do. While climate and decarbonization is front and center on the minds of AOs, biodiversity is emerging as more significant area of focus, and the "S" in ESG (i.e., diversity & equity) is gaining more attention with the pandemic.

Our sincere thanks to the investment professionals who participated in the qualitative phase of our study. We are looking forward to engaging with our clients, key stakeholders, and the broader market in the coming months and sharing the results of our quantitative survey later this year.

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