2024 INSTITUTIONAL INVESTOR SURVEY ON SUSTAINABILITY

HOOVER INSTITUTION

ROCK CENTER FOR CORPORATE GOVERNANCE STANFORD

STANFORD BUSINESS GRADUATE SCHOOL OF

IN COLLABORATION WITH MSCI SUSTAINABILITY INSTITUTE

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INTRODUCTION

It is my privilege to introduce this survey of some of the world's largest investors.

Last fall, we asked institutional owners and managers of assets, nearly half of whom manage more than $250 billion in assets, for their views on sustainable investing.

The survey, fielded by researchers at Stanford Graduate School of Business, the Hoover Institution Working Group on Corporate Governance, and the Rock Center for Corporate Governance in collaboration with the MSCI Sustainability Institute, shows that the lion's share of global investors either consider environmental, social, and governance factors as central to their decisions or as a factor in shaping their strategies.

It shows that regional differences notwithstanding, risk-minded investors are paying attention to climate-related financial risk, the opportunity that comes with the shift to a clean-energy economy, and the importance of sound governance. They're also examining such emerging risks as the security and privacy of data.

The survey also shows that consideration of sustainability risks ties into financial performance. Most investors we surveyed say that such risks are industry-specific. Nearly every investor would pass on an investment, regardless of its sustainability profile, whose financial fundamentals alone would not make it an attractive investment.

LINDA-ELING LEE

Founding Director and Head
MSCI Sustainability Institute

EXECUTIVE SUMMARY AND KEY FINDINGS

The majority of institutional investors on both sides of the Atlantic consider sustainability risks in their decision-making, but differently.

Traditional governance factors dominate the list of most important environmental, social, and governance considerations.

The world's largest investors overwhelmingly believe that climate change will impact portfolios, but do not think climate risks are fully reflected in asset prices.

The environment is substantially about climate change for many fund managers.

While social factors play a limited role in investment selection, investors cite data security and privacy among the top ESG factors they explicitly consider.

Investors would like to see companies pay attention to the quality of their governance in the short term and cut carbon footprints over time.

More than two-thirds of investors in Europe and North America stated that governance-related factors are most important to their investment decisions, particularly over the short term. Climate risk, in contrast, dominates the medium term, with 93% of investors stating that climate issues are most likely to affect the performance of investments over the next two to five years.

Those are among the key findings in this survey of major institutional investors by Stanford Graduate School of Business, the Hoover Institution Working Group on Corporate Governance, and the Arthur and Toni Rembe Rock Center for Corporate Governance at Stanford University. The survey was conducted in collaboration with the MSCI Sustainability Institute, which asked major institutional owners and managers of assets how they incorporate ESG factors into investment decisions.

"While ESG integration has become mainstream, governance reigns supreme," observes Amit Seru, The Steven and Roberta Denning Professor of Finance at Stanford Graduate School of Business and a senior fellow at the Hoover Institution, who led the survey. "Institutional investors rank governance factors as more important to an investment decision than environmental and social factors. At the same time, climate considerations have come to the forefront, with the largest investors believing overwhelmingly that climate change will impact their portfolios in the coming years."

“Corporate governance is table stakes: All companies are expected to have it,” adds David F. Larcker, The James Irvin Miller Professor of Accounting, Emeritus, at Stanford Graduate School of Business and co-director of the Hoover Institution Working Group on Corporate Governance. “Governance has been a topic of investment focus for a very long time and, while critically important, investors see governance quality as already embedded in asset prices. By contrast, despite believing in the impact of climate on portfolios, investors see climate risks as yet to be fully priced. Social factors appear to be largely unimportant for driving investment decisions.”

The survey included interviews with senior decision-makers at 47 institutional investment firms and asset managers in North America (49%), Europe (47%), and Asia (4%) in the fall of 2023 who were asked how they incorporate ESG factors into investment decisions. Forty-three percent of institutions surveyed manage more than US $250 billion in assets, while one-third (34%) manage between US $10 and $250 billion. Over 80% of respondents included CIOs, CROs, and heads of research and portfolio management.

KEY FINDINGS INCLUDE THE FOLLOWING:

ESG integration is mainstream but is predominantly about governance

More than three-quarters of investors globally consider ESG (among other factors) in their decision-making. Institutional investors rank governance quality as the most important ESG factor, with 68% of investors saying governance ranks highest in an investment decision. By comparison, only 23% say environmental factors are most important to an investment decision, and 2% cite social factors. Virtually no investors surveyed disregard ESG completely.

“Investors are laser-focused on traditional concepts of shareholder value,” comments Seru. “Corporate governance issues dominate investors’ list of the most important ESG factors. Surprisingly, social and environmental factors ranked lower. Of these, only climate change appears to be meaningfully important. Other issues, including how companies source materials, the pollution they generate, or their pay practices barely make the grade.”

- When asked which ESG factors fund managers explicitly consider as part of an investment decision, climate change ranks as the most important, selected by 78% of respondents. After this, the next four factors are all governance-related: board structure (72%), ownership structure (72%), board diversity (65%), and quality of financial reporting (57%).
- The least important ESG factors according to respondents are the ratio of CEO pay to the pay of the average worker (20%), pollution and waste byproducts (24%), packaging and product waste (24%), and raw material sourcing (26%).
- Most investors (67%) consider ESG quality as one of many factors when making an investment decision; 2% use it to screen out potential investments, while 11% do not rely on it at all. Overall, 59% say ESG is important, while 41% say it is not.

ESG is primarily about risk reduction, and it is industry-specific

The nature of ESG risk changes with investment horizon. In the short term (less than two years), investors expect governance factors to have the largest impact on the performance of an investment. Three-quarters of investors (76%) believe governance quality impacts two-year performance, while 59% believe environmental factors impact two-year performance and 30% social factors. Over longer time horizons (two to five years), environmental factors become much more important.

- Most institutional investors (80%) believe ESG has an impact on the financial performance of an investment, and that ESG performance is industry-specific (77%).
- 78% believe ESG reduces tail risk, 61% that it reduces volatility, and 43% that it improves a portfolio's Sharpe ratio. These responses are consistent with empirical studies that find an association between ESG and risk. Only 37% believe ESG generates alpha while 20% believe ESG does not impact financial performance.
- Similarly, 63% of respondents say that investors consider ESG because it offers a more "holistic" view of risk than standard investment frameworks.
- Investors express diverging opinions about the degree to which ESG risk is reflected in today's asset prices. Almost all (98%) say that governance risks are appropriately reflected in prices, and a large majority (76%) say the risk of climate change is mostly or somewhat reflected in prices. By contrast, only 50% say environmental risks (other than climate change) and 46% say social risks are reflected in asset prices.
- While just 2% of investors say that social factors are most important to their decisions, data security and privacy ranks as among the top seven ESG factors that investors say they consider explicitly.

"Despite the publicity that corporations have generated through investment in their workforces, fund managers clearly view social factors as ancillary and less important to an investment than governance and environmental commitments," comments Larcker. "Social initiatives do not appear to make a company a more attractive investment. By contrast, enhancing governance quality and investing in environmental preparedness are seen as decreasing long-tail risk. Another perspective may be that the mechanisms for pricing social risks are yet to be developed, which may be an opportunity for some."

Climate takes focus

Investors overwhelmingly consider climate change as the environmental factor driving investment decision-making, eclipsing sourcing of raw materials, the sustainability of supply chains, or packaging and product waste as risks of concern.

- Nearly all investors surveyed (93%) ranked climate issues as the most likely to affect the performance of investments over the next two to five years.
- Most (95%) of investors in Europe say they analyze the emissions of their investments, compared with 85% of their peers in North America.
- That being said, only 4% of investors say climate-related risks are reflected in the current price of financial assets, while three-quarters (72%) say such risks are somewhat reflected in asset values.

Investors on both sides of the Atlantic consider environmental, social, and governance risks in their decision-making, but differently

Surprisingly, we find little divergence between the viewpoints of European and North American institutional investors, despite the fact that European investors are much more likely to operate under an ESG mandate.

- In our sample, three-quarters of European respondents (73%) operate under an investment mandate that limits their investment choices based on ESG criteria, compared with only a quarter (26%) of North American respondents.
- Nevertheless, North American institutional investors are no less likely to believe that ESG reduces portfolio risk, and they have similar views on how ESG factors affect short- and long-term performance. They also have similar views as European investors regarding the degree to which ESG risks are incorporated into asset prices.
- Still, we find some differences. European investors are more likely to say ESG is important to their investment decision (69% versus 50% among North American investors).
- European investors are more likely to consider the impact of climate change (86% versus 73%) and to evaluate net zero pledges (64% and 36%) as part of the investment process. They are also much more likely to consider data security and privacy (73% versus 36%), and they pay closer attention to board structure (82% versus 59%).

Investors use ESG to weed out bad actors

Investors are more likely to drop a firm with poor ESG characteristics, but great ESG quality does not make up for poor underlying financials.

- For example, 40% of investors would remove a company with strong financial performance from consideration if its ESG characteristics were poor, while most (84%) would not consider investing in a company with positive ESG characteristics whose fundamentals alone are not attractive.

- Institutional investors estimate that ESG considerations shrink the investable universe of companies by an average of 22% (19% median).
- In terms of ESG ratings, investors are divided on whether a company in a "bad" industry can merit a high ESG score because of the way it manages other aspects of the business, with 23% believing that it can and 21% that it cannot. (The remainder believe the answer depends on the nature of the company's business.) By contrast, most (72%) say that a company in a "good" industry can still merit a poor ESG rating because of the way it manages its business.

"These results really highlight the asymmetric nature of ESG in the investment decision process," says Larcker. "You can be a bad company in a good industry and get punished, but if you are a good company in a bad industry, you get a break."

Furthermore, most investors view ESG as a relative quality. That is, they measure ESG relative to industry peers, rather than against absolute standards of performance. 77% measure ESG relative to peers, while only 18% do so on an absolute basis.

"Investors are not withdrawing from entire industries unless they have a mandate to do so," adds Larcker. "Instead, they are trying to weed out the worst offenders. It's very much an exercise of relative comparison."

ESG as a staple or luxury good?

The findings of this study are related to the 2023 findings of the annual survey of investors, retirement savings, and ESG conducted by Stanford Graduate School of Business, the Hoover Institution Working Group on Corporate Governance, and the Rock Center for Corporate Governance. That study found that tightened market conditions have dramatically reduced the willingness of individual shareholders to pay for ESG-related initiatives among the companies they own.

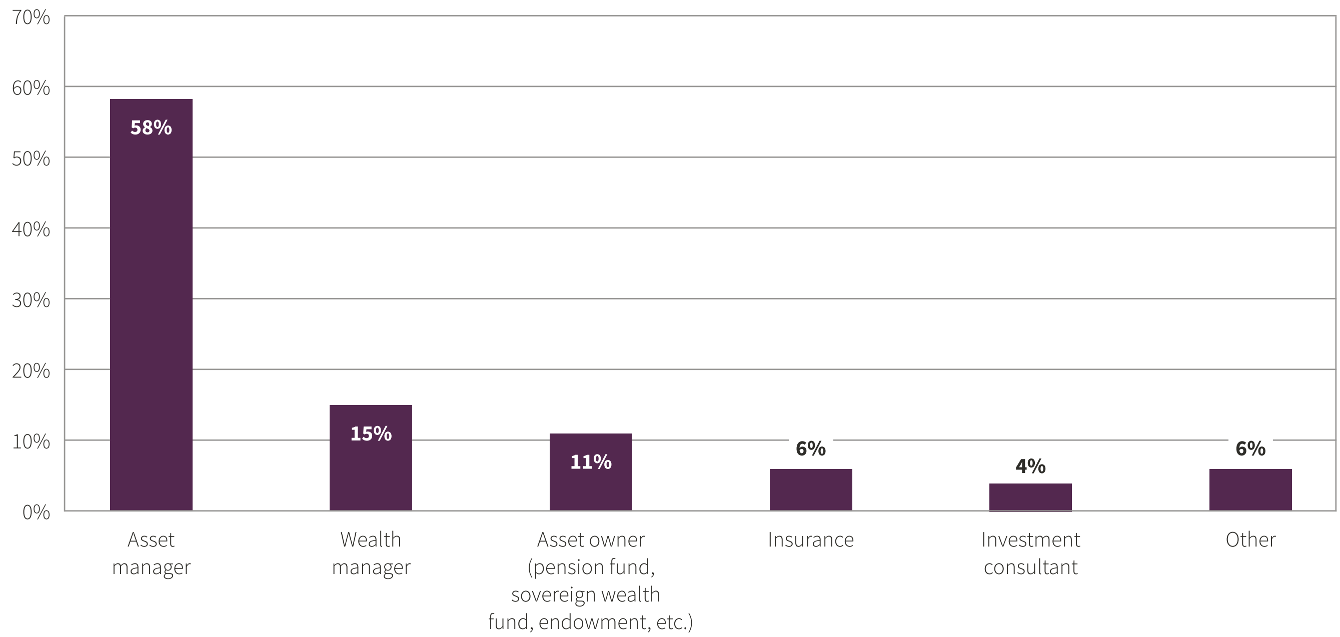
"The majority of institutional investors globally consider ESG factors as either central or supplementary to making investment decisions, but don't perceive its sub-components to be priced to the same degree," observes Seru. "Mandate specificity can dictate how ESG is implemented, which is where divergence emerges between European and North American investors."

"Our other survey work showed that for some other (retail) investors, ESG is not a must-have feature of the corporate purpose. Instead, it looks as if ESG is a luxury good. They are willing to support it when profits and stock prices are high but willing to forgo it when profitability struggles."

SURVEY RESULTS

Which of the following most closely describes your organization?

ALL RESPONDENTS

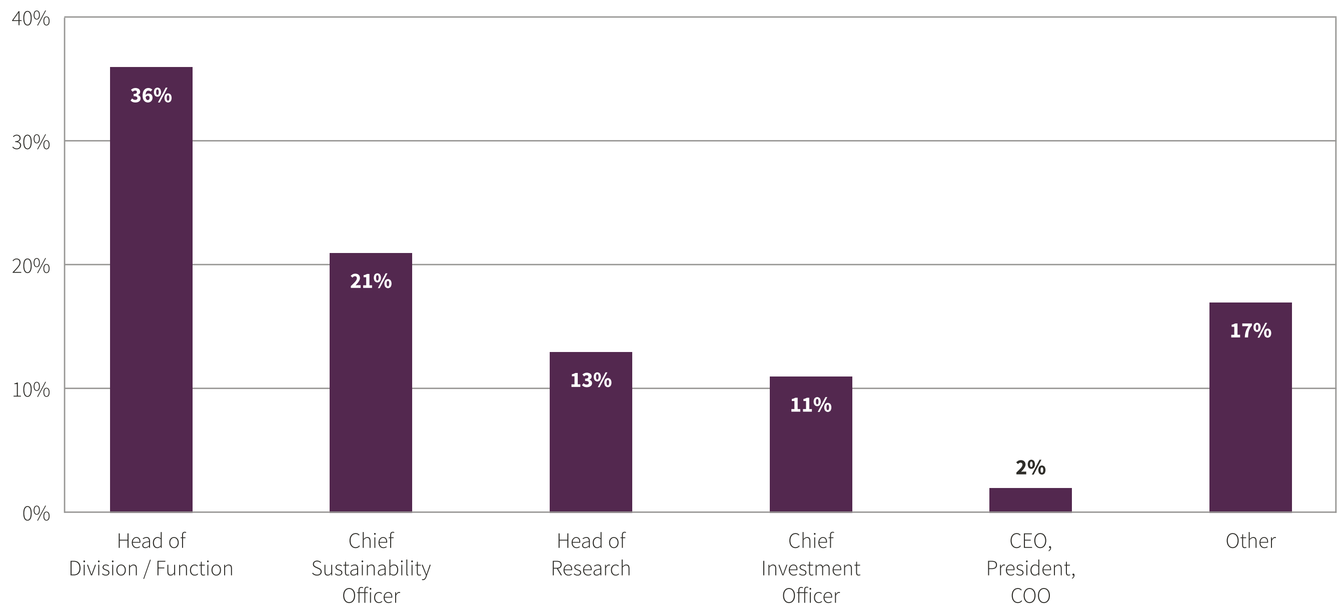


Which region is your firm headquartered in?

ALL RESPONDENTS

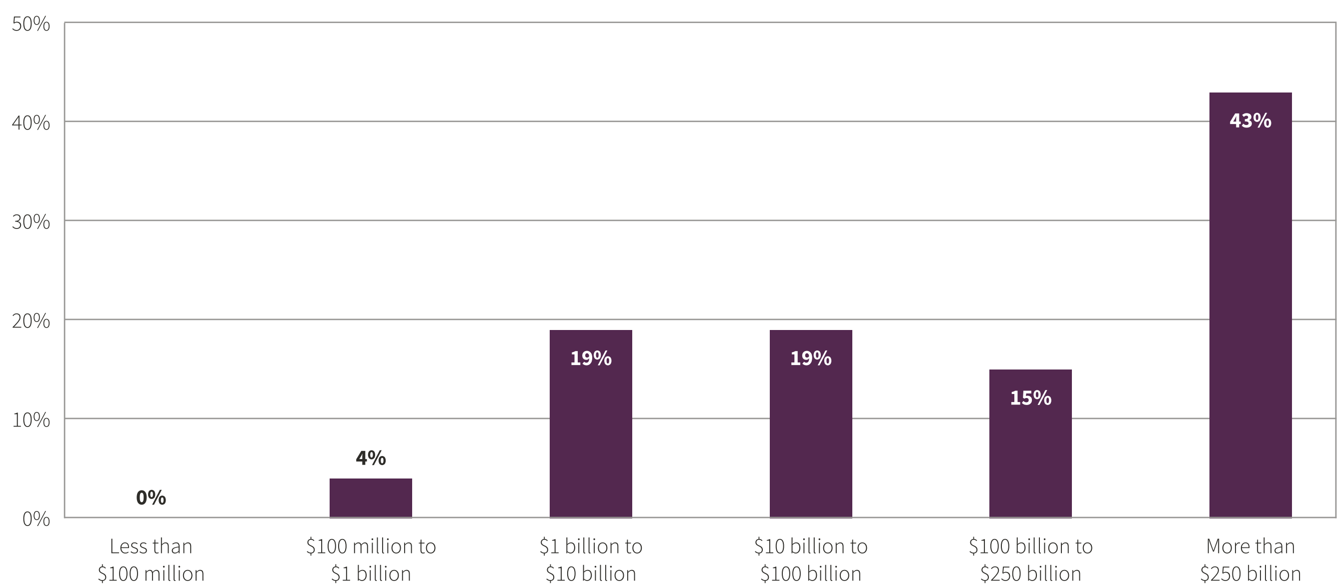
What is your role within the organization?

ALL RESPONDENTS



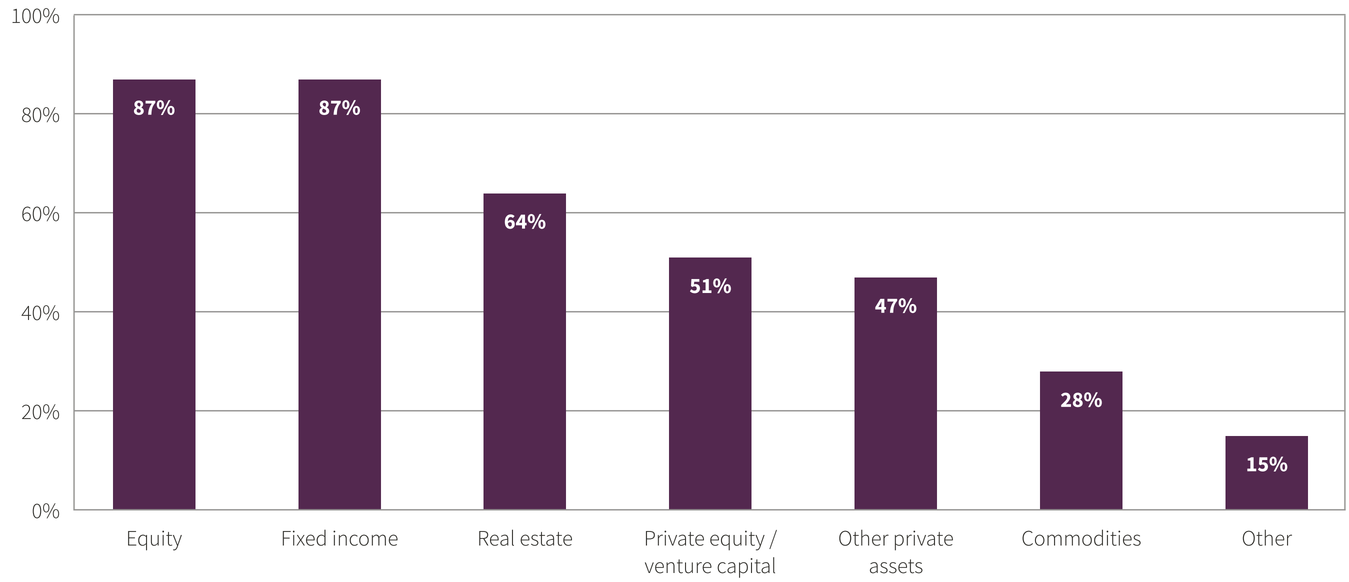
What is the total amount of assets that your organization owns or has under management?

ALL RESPONDENTS



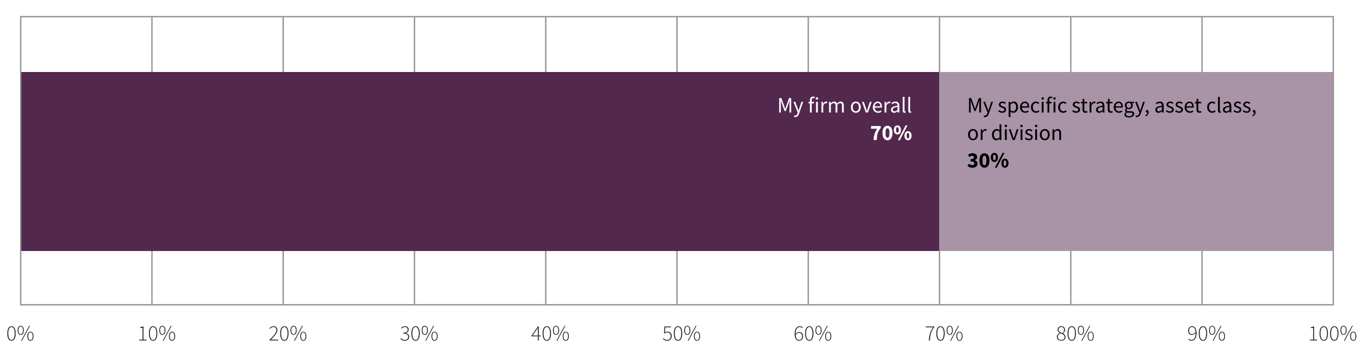
Which of the following asset classes does your firm manage or own? (select all that apply)

ALL RESPONDENTS

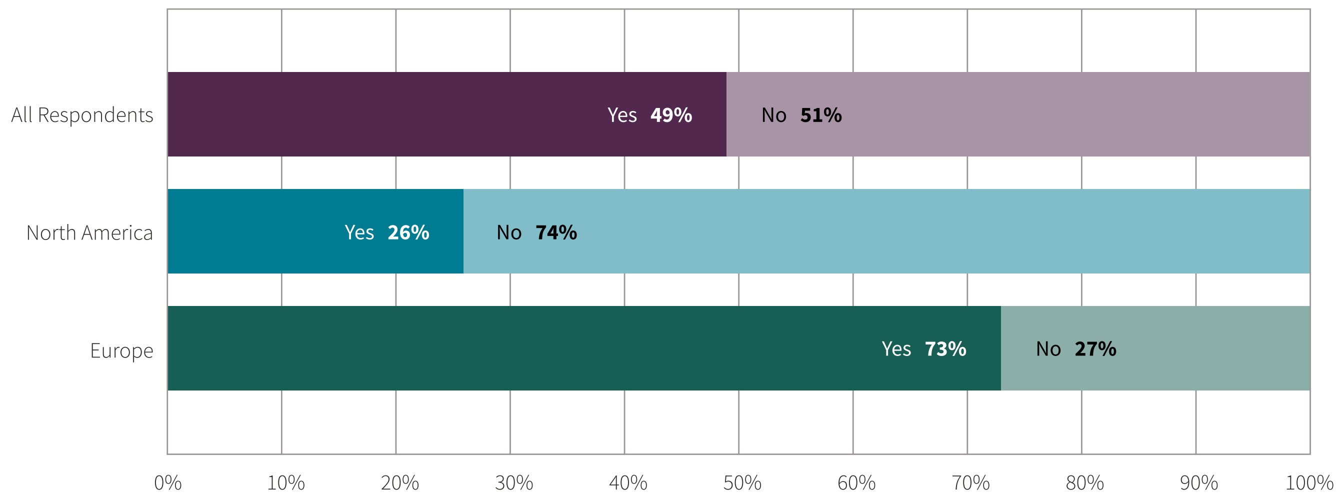


Are you answering this survey on behalf of your firm overall or on behalf of your specific strategy, asset class, or division within the firm?

ALL RESPONDENTS



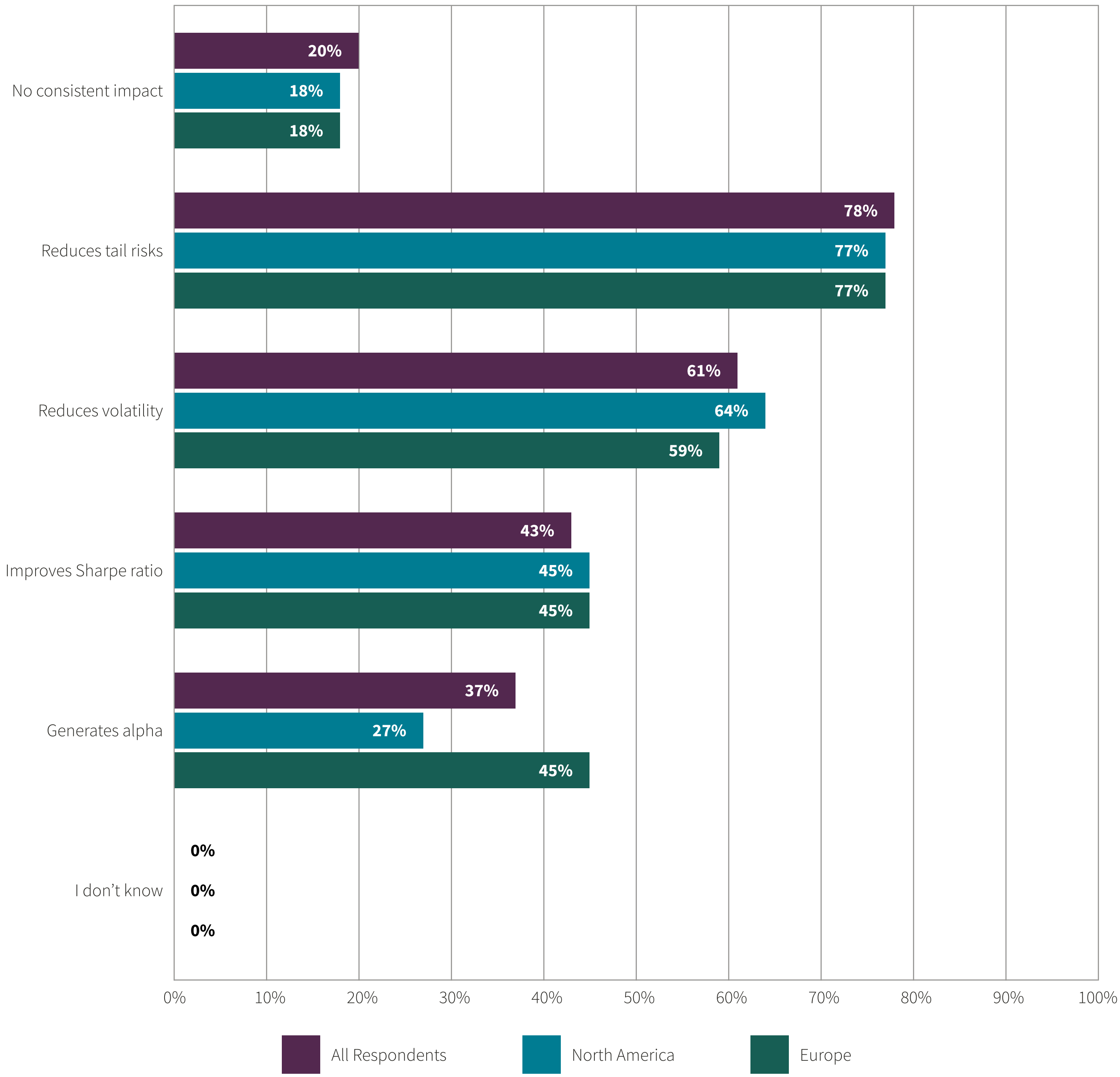
Do you operate under an investment mandate that limits your investment choices based on ESG criteria?



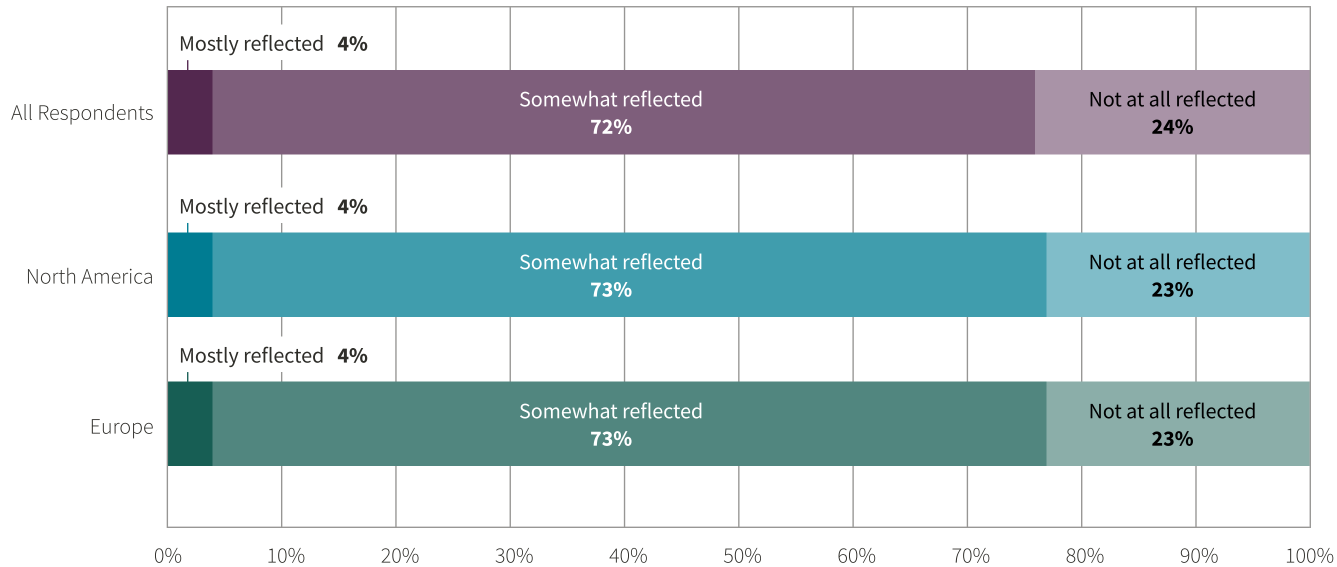
Many investors are making commitments to address environmental and social issues. Which of the following statements most accurately reflects your view of these commitments?

ALL RESPONDENTS

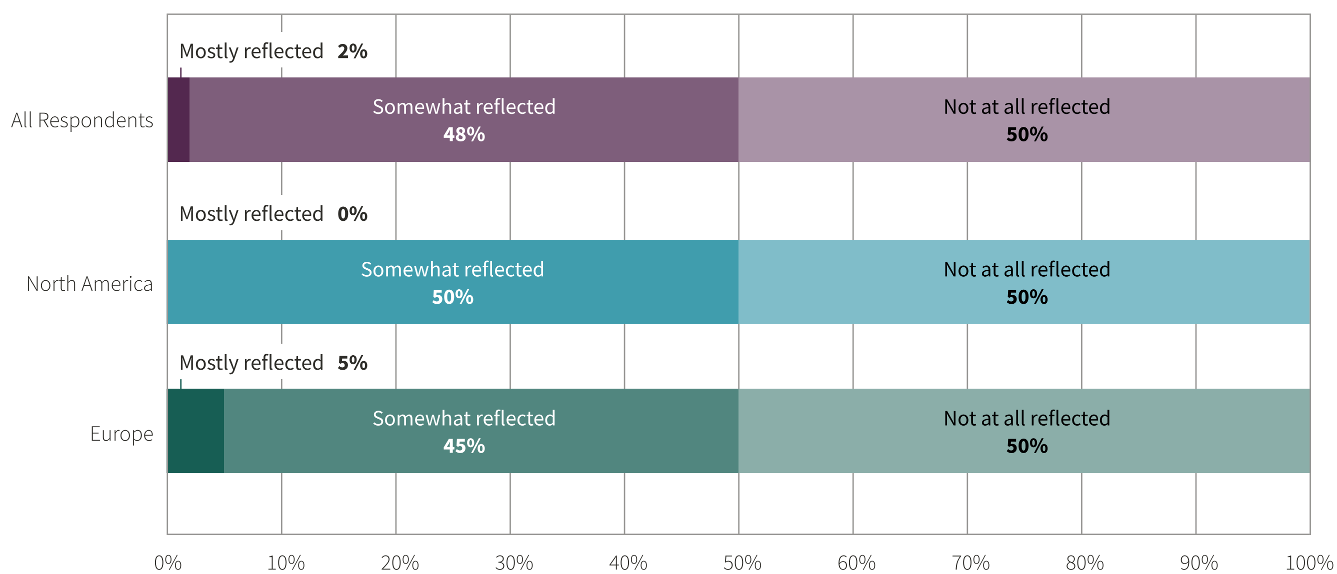
What impact do you believe a commitment to integrating ESG criteria has on the performance of an investment? (select all that apply)



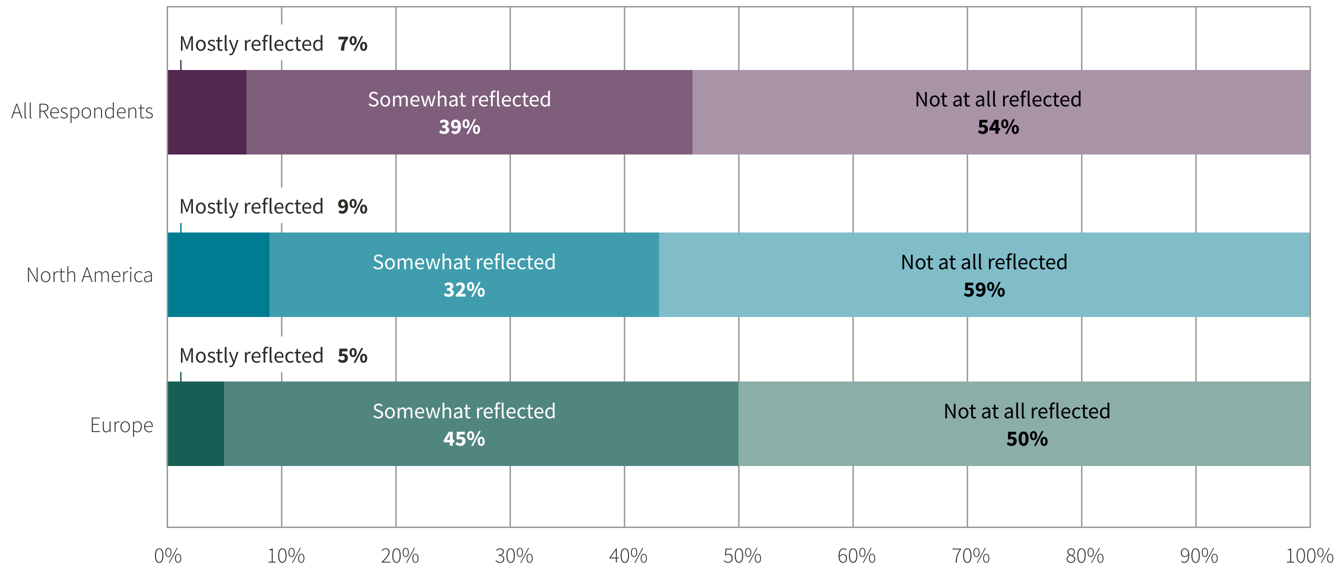
To what extent do you think **climate-related** risks are already reflected in the pricing of assets today?



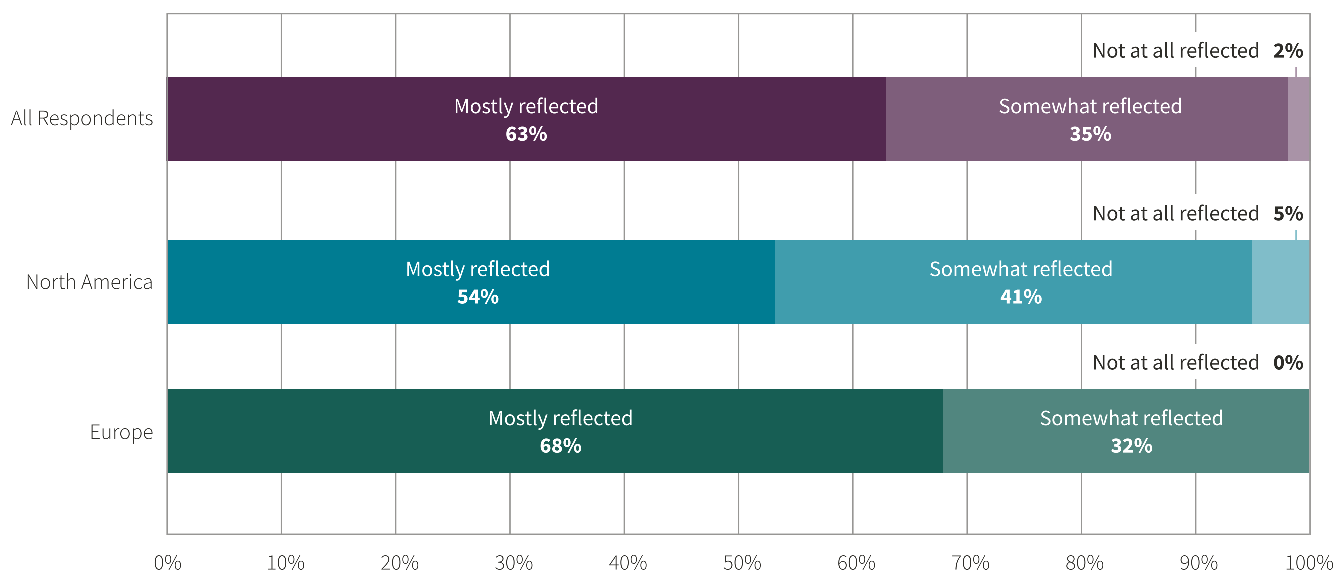
To what extent do you think **environmental** risks (other than climate change) are already reflected in the pricing of assets today?



To what extent do you think **social** risks (such as risks involving human capital and the labor practices of supply chains) are already reflected in the pricing of assets today?

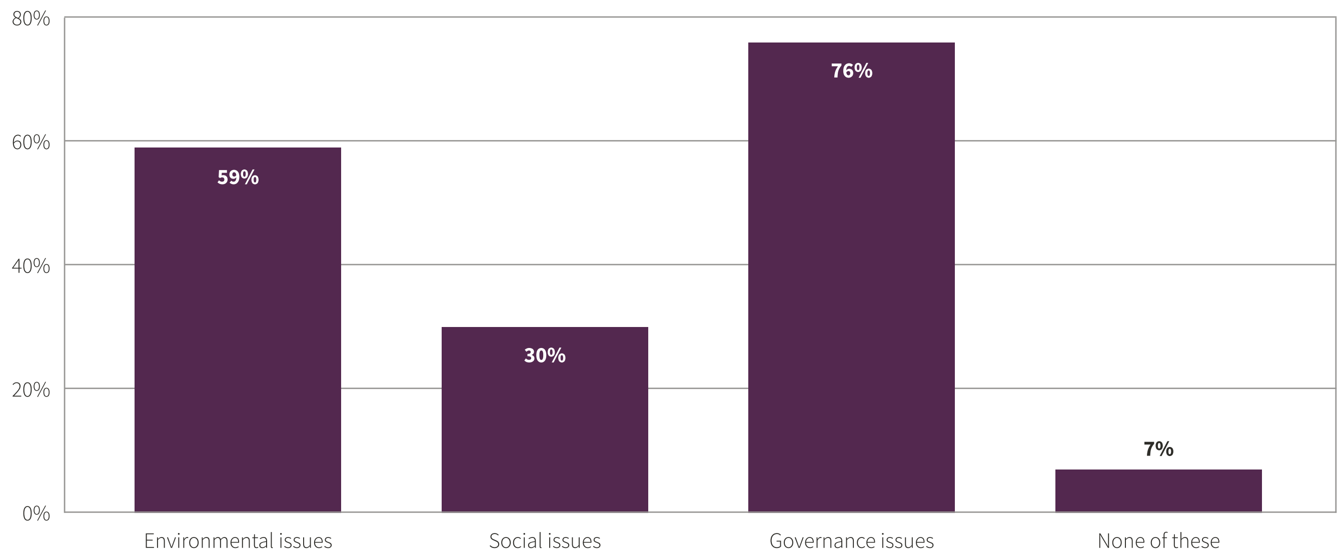


To what extent do you think **governance** risks (such as board oversight, financial reporting quality, and tax transparency) are already reflected in the pricing of assets today?



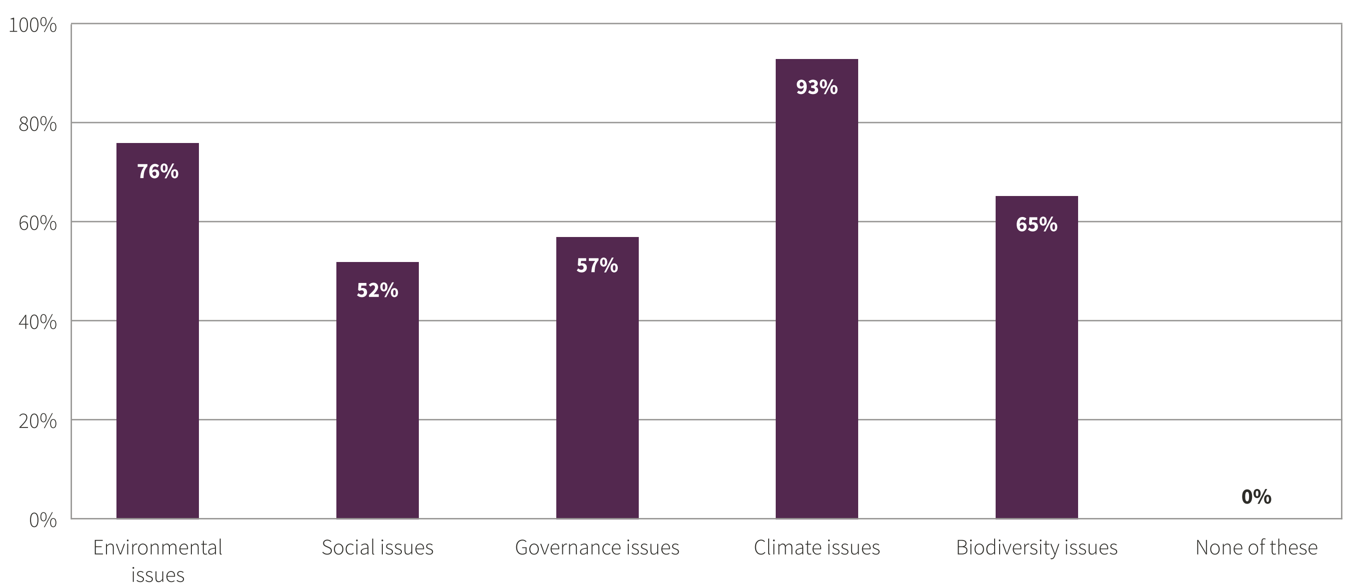
Which ESG issues do you believe are most likely to affect the performance of an investment in **the next 24 months?** (select all that apply)

ALL RESPONDENTS



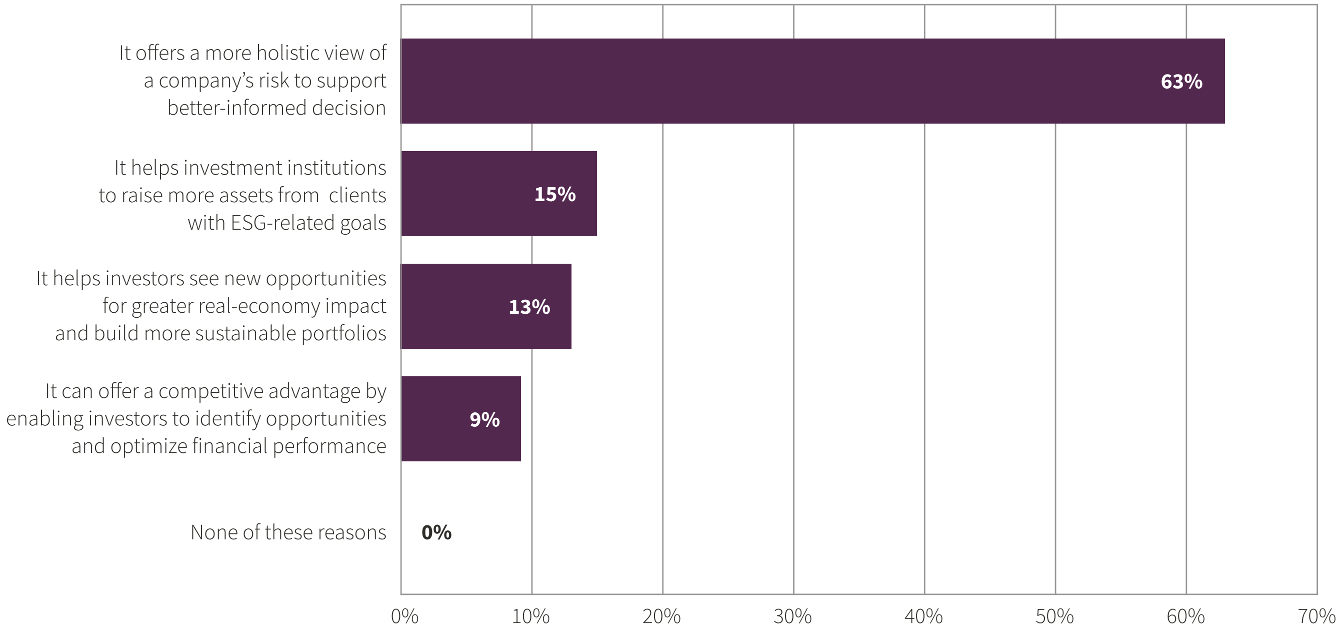
Which ESG issues do you believe are most likely to affect the performance of an investment over **the next 2 to 5 years?** (select all that apply)

ALL RESPONDENTS

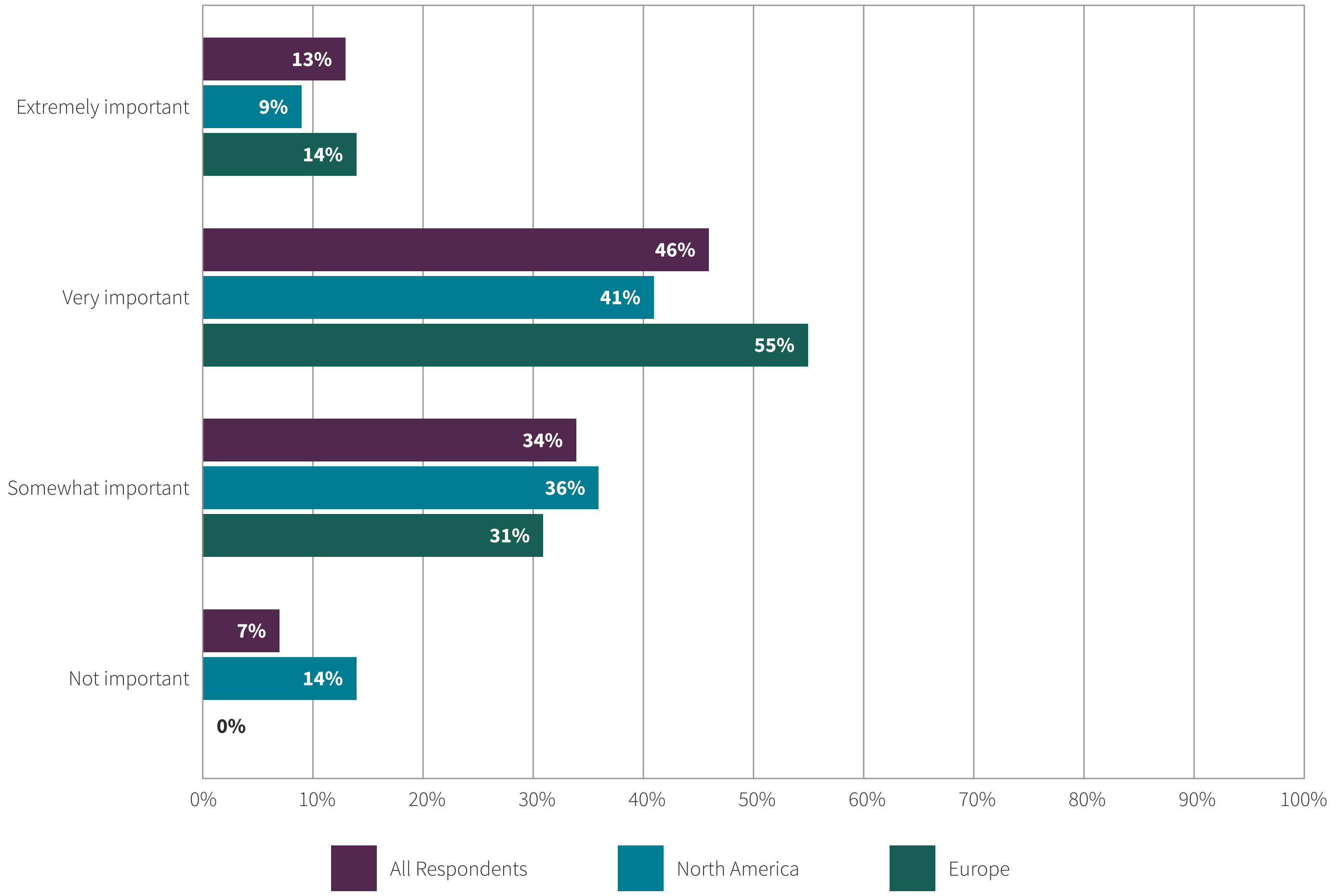


Which of the following do you believe best describes the reason your peers in the industry consider ESG factors as part of investment decision-making?

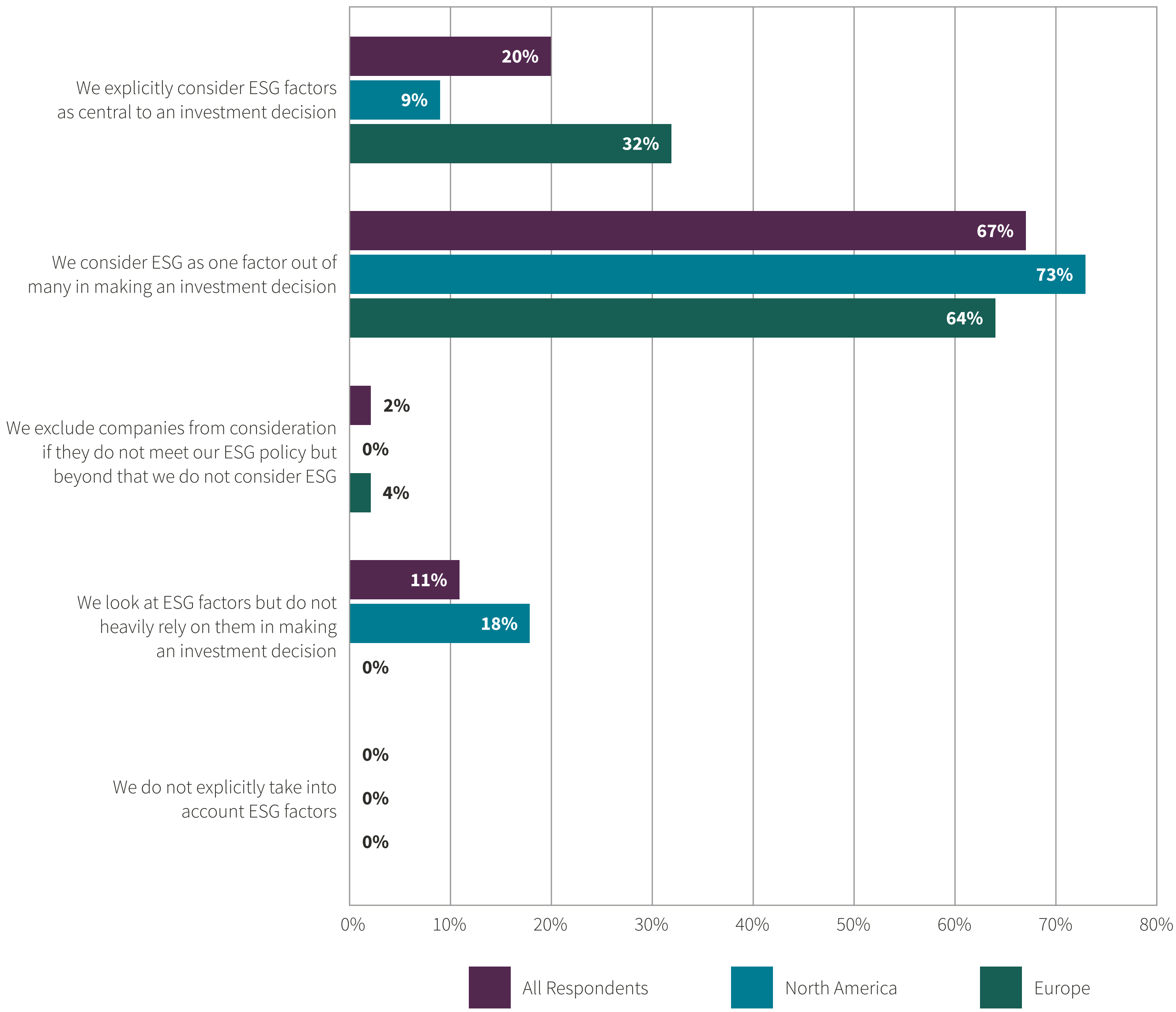
ALL RESPONDENTS



How important are ESG criteria in your overall investment decision process?

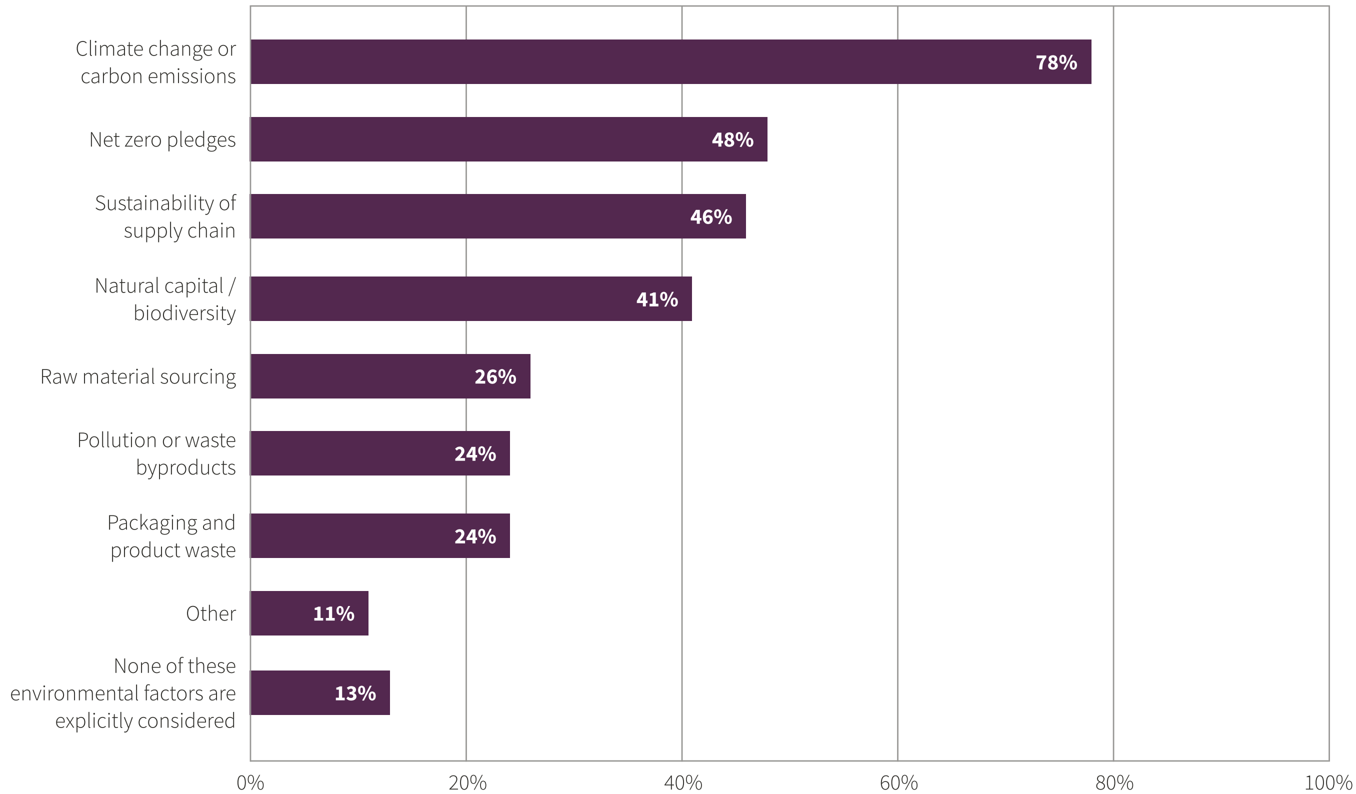


Which of the following best describes how you use ESG criteria in investment decisions?

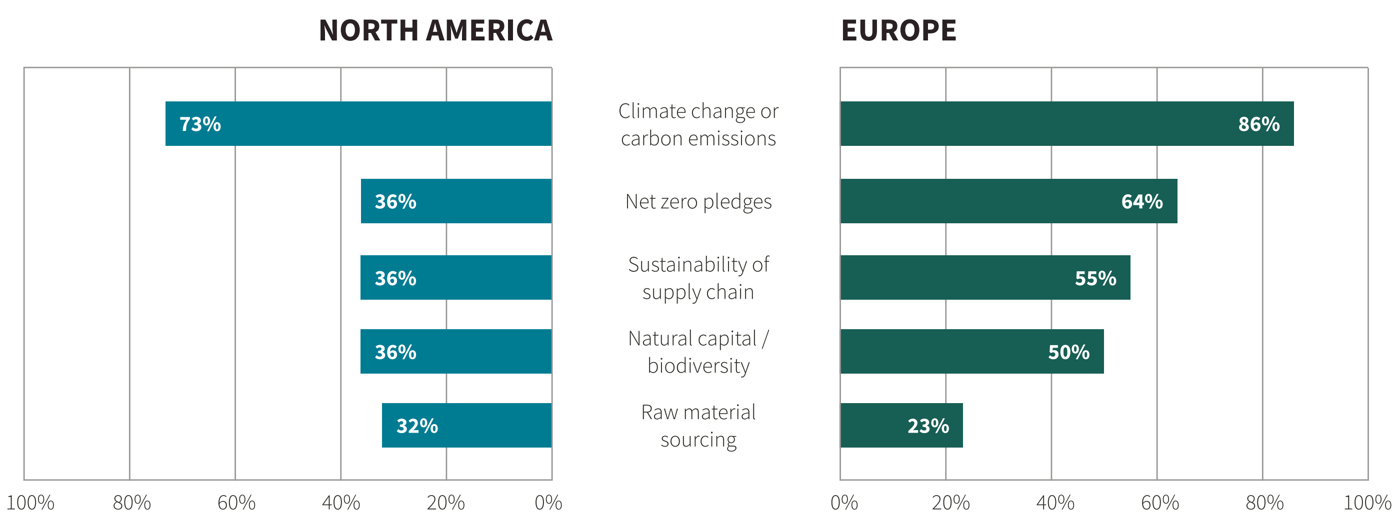


Which of the following **environmental** factors do you explicitly consider in the process for investment decisions? (select all that apply)

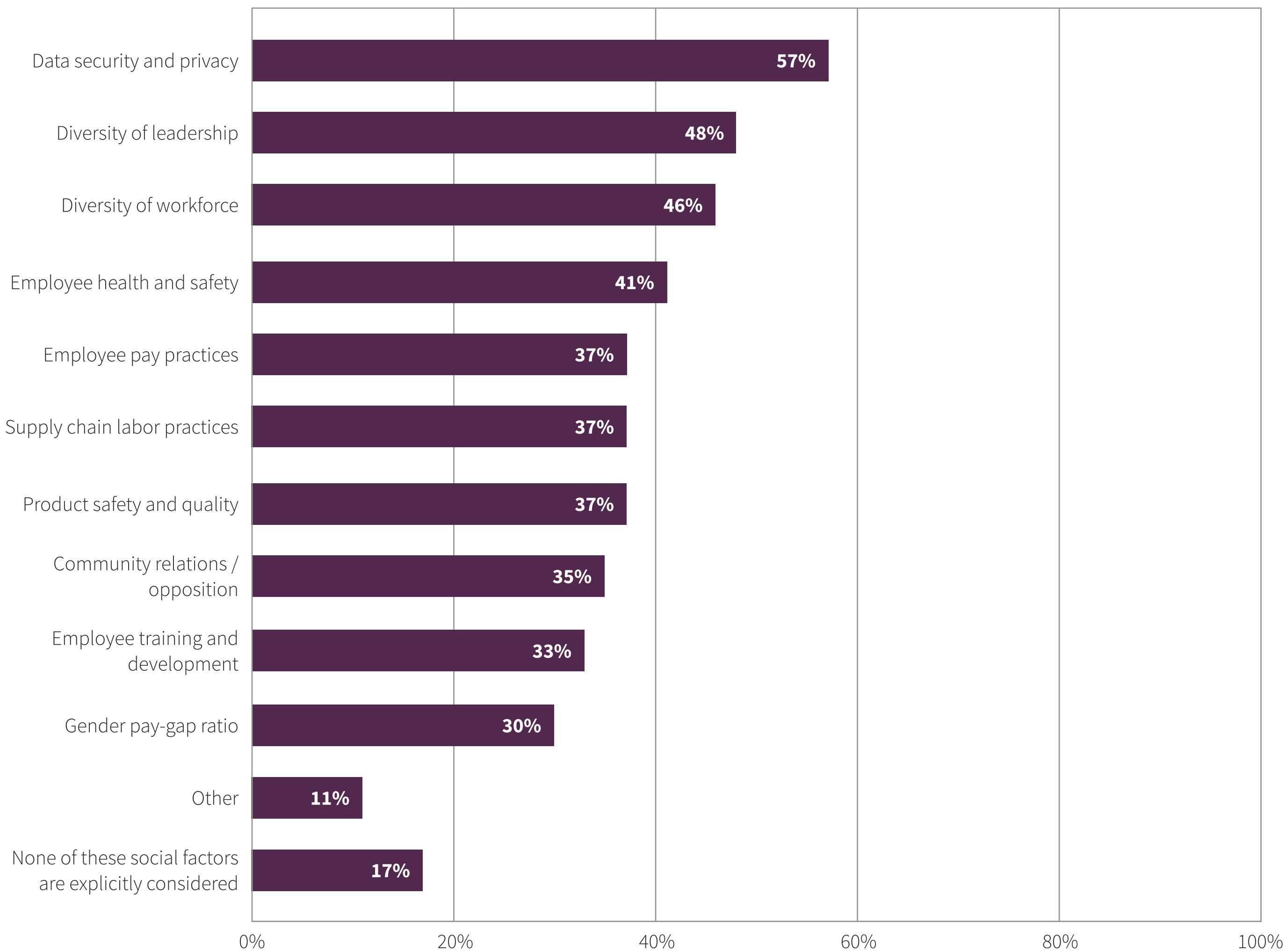
ALL RESPONDENTS



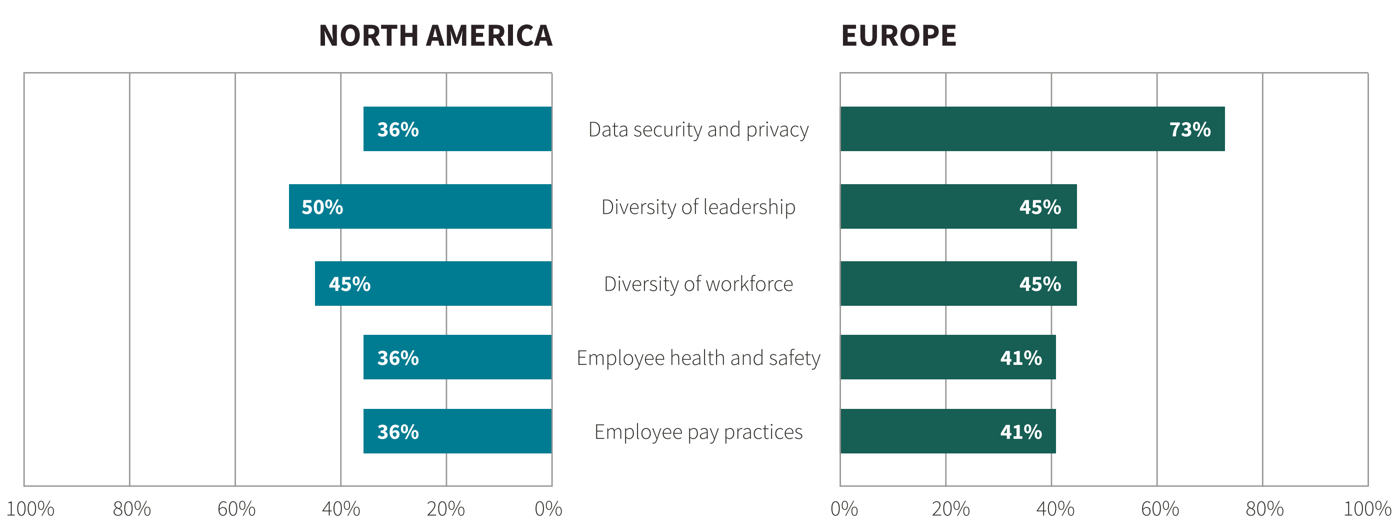
TOP 5 ENVIRONMENTAL FACTORS



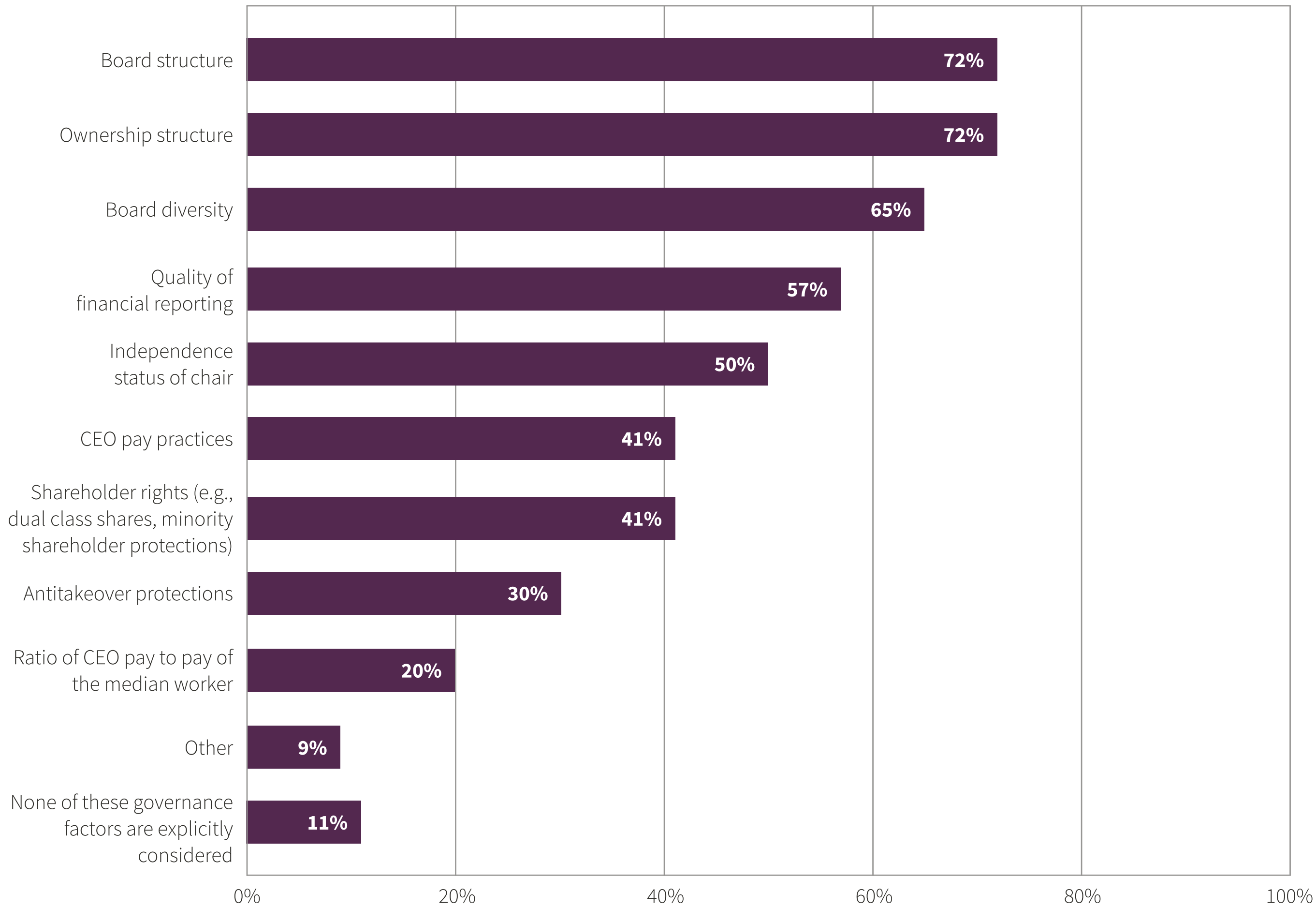
Which of the following **social** factors do you explicitly consider in the process for investment decisions? (select all that apply)



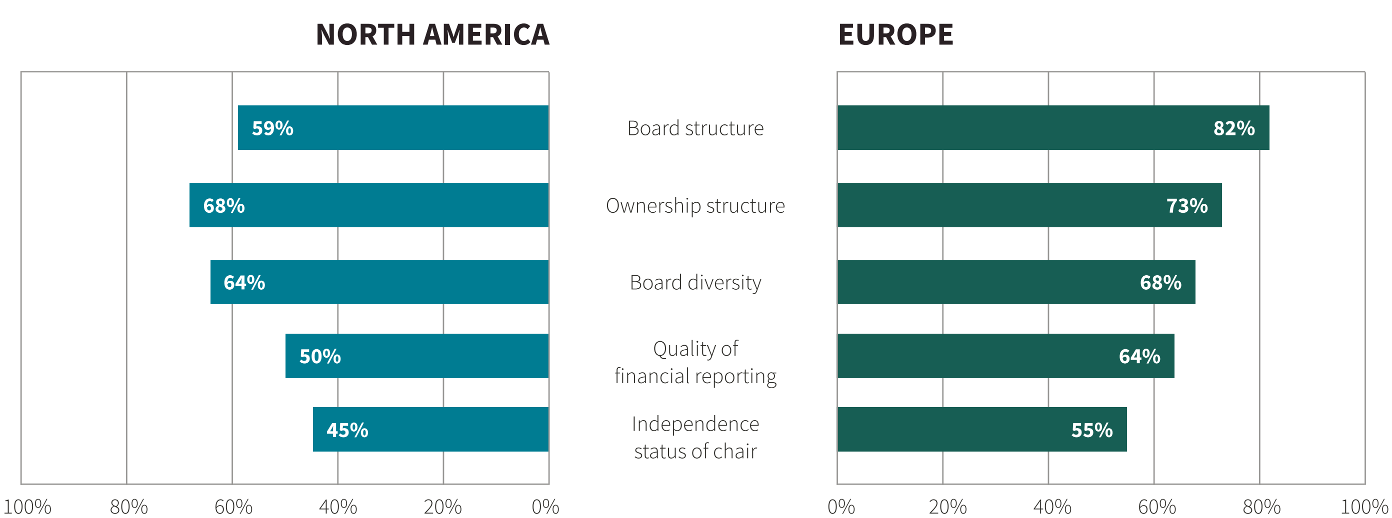
TOP 5 SOCIAL FACTORS



Which of the following **governance** factors do you explicitly consider in the process for investment decisions? (select all that apply)



TOP 5 GOVERNANCE FACTORS



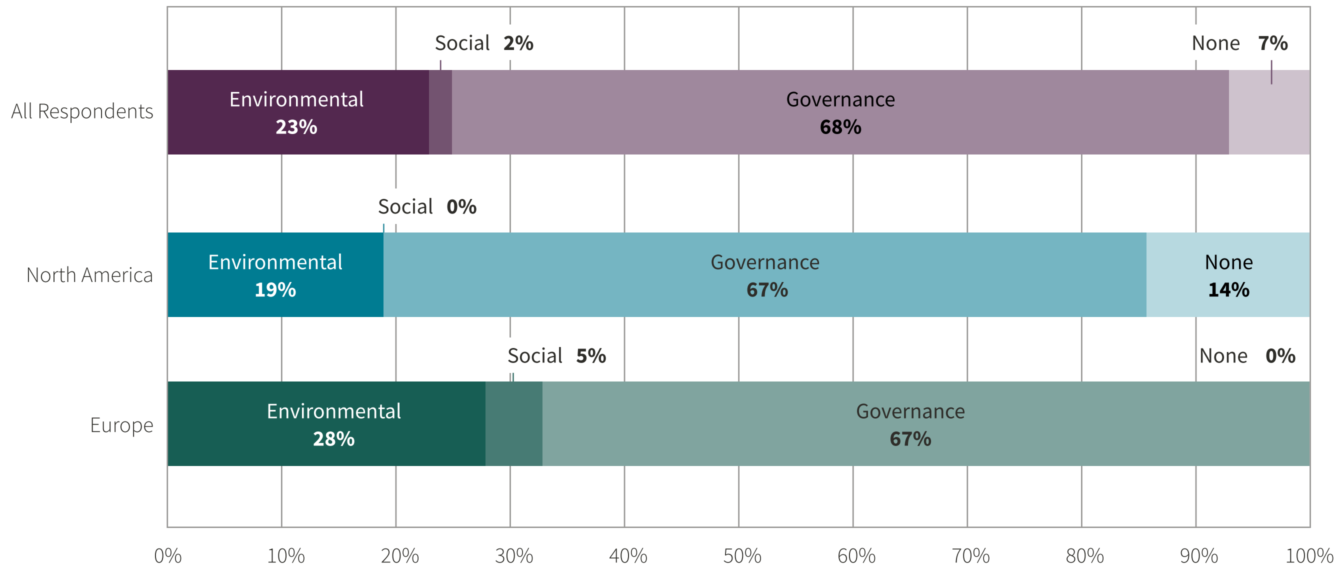
TOP 7 ESG FACTORS EXPLICITLY CONSIDERED

ESG FACTOR	TYPE	PERCENTAGE
Climate change or carbon emissions	Environmental	78%
Board structure	Governance	72%
Ownership structure	Governance	72%
Board diversity	Governance	65%
Quality of financial reporting	Governance	57%
Data security and privacy	Social	57%
Independence status of chair	Governance	50%

BOTTOM 7 ESG FACTORS EXPLICITLY CONSIDERED

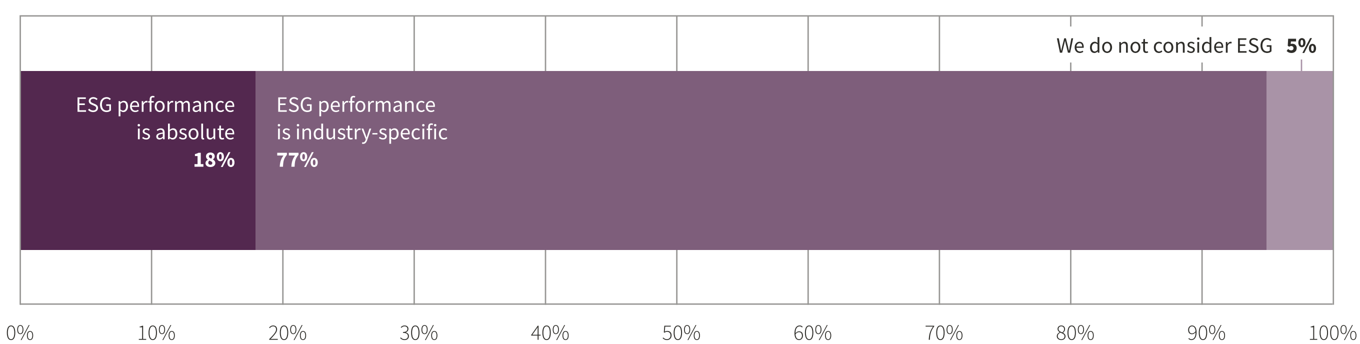
ESG FACTOR	TYPE	PERCENTAGE
Ratio of CEO pay to pay of the median worker	Governance	20%
Pollution or waste byproducts	Environmental	24%
Packaging and product waste	Environmental	24%
Raw material sourcing	Environmental	26%
Gender pay-gap ratio	Social	30%
Antitakeover protections	Governance	30%
Employee training and development	Social	33%

In general, which of the following are most important to your investment decisions?



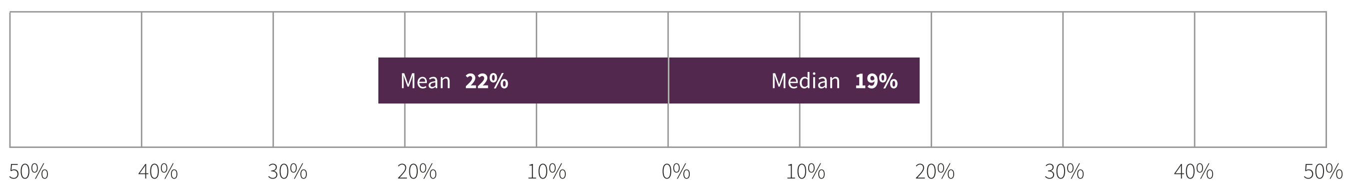
Does your investment process consider ESG performance from an absolute or relative perspective? (i.e., do you compare a firm's ESG performance relative to its peers or do you consider its ESG performance on an absolute basis regardless of industry)

ALL RESPONDENTS



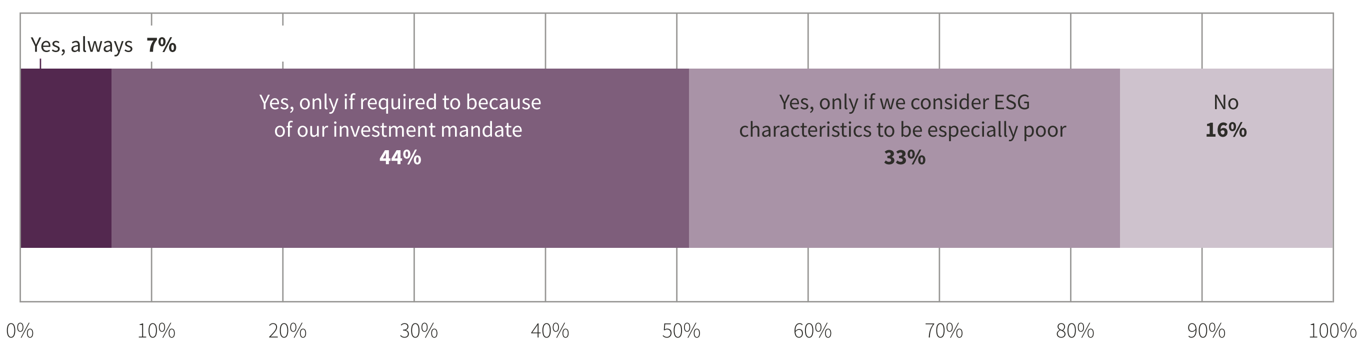
How much does the consideration of ESG criteria shrink the initial universe of companies that you have the potential to invest? (on a scale of 0 to 100, with 0 representing “not at all” and 100 representing “entirely”)

ALL RESPONDENTS



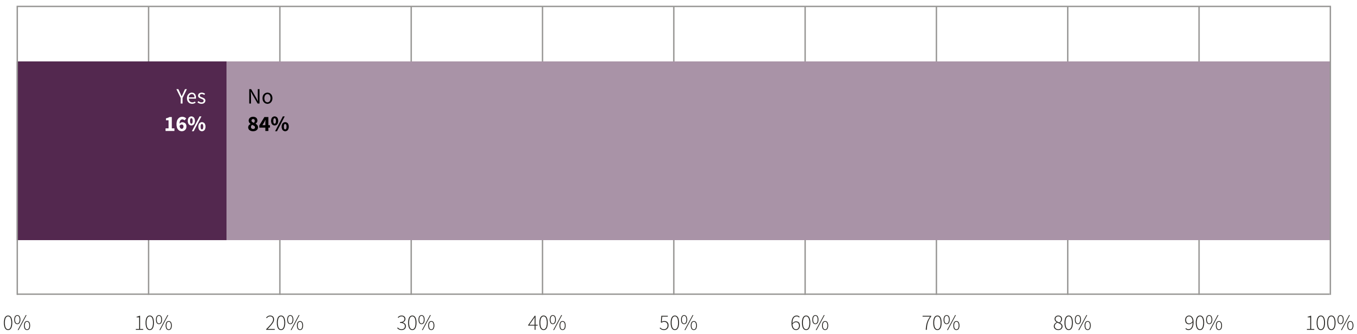
Would you exclude a company with strong financial fundamentals from investment consideration solely because you deem it to have poor ESG characteristics?

ALL RESPONDENTS



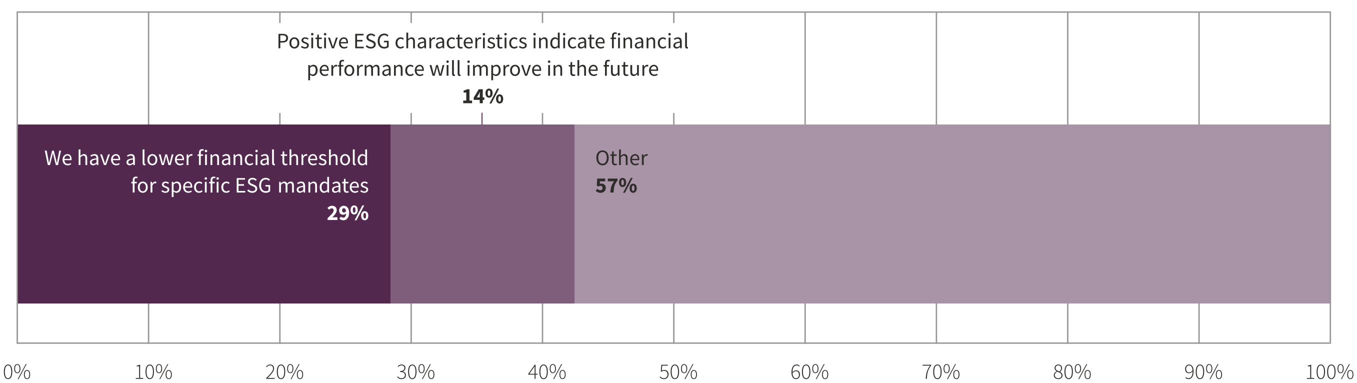
Would you consider investing in a company with positive ESG characteristics whose financial fundamentals alone would not clearly make it an attractive investment?

ALL RESPONDENTS



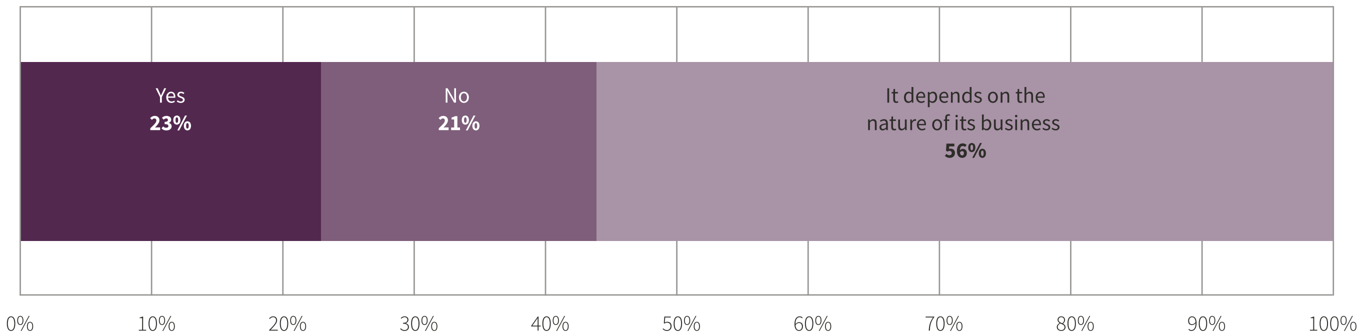
Why?

ALL RESPONDENTS



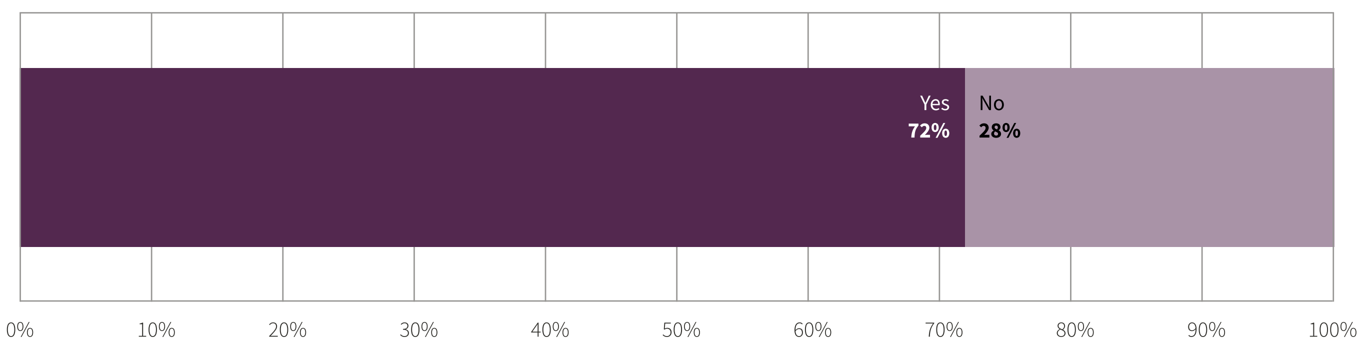
Do you believe that a company that might merit a poor ESG score because of the controversial nature of its industry or product (e.g., a coal company or tobacco company) should still be able to earn a high ESG score because of the positive way it manages other ESG factors or criteria?

ALL RESPONDENTS

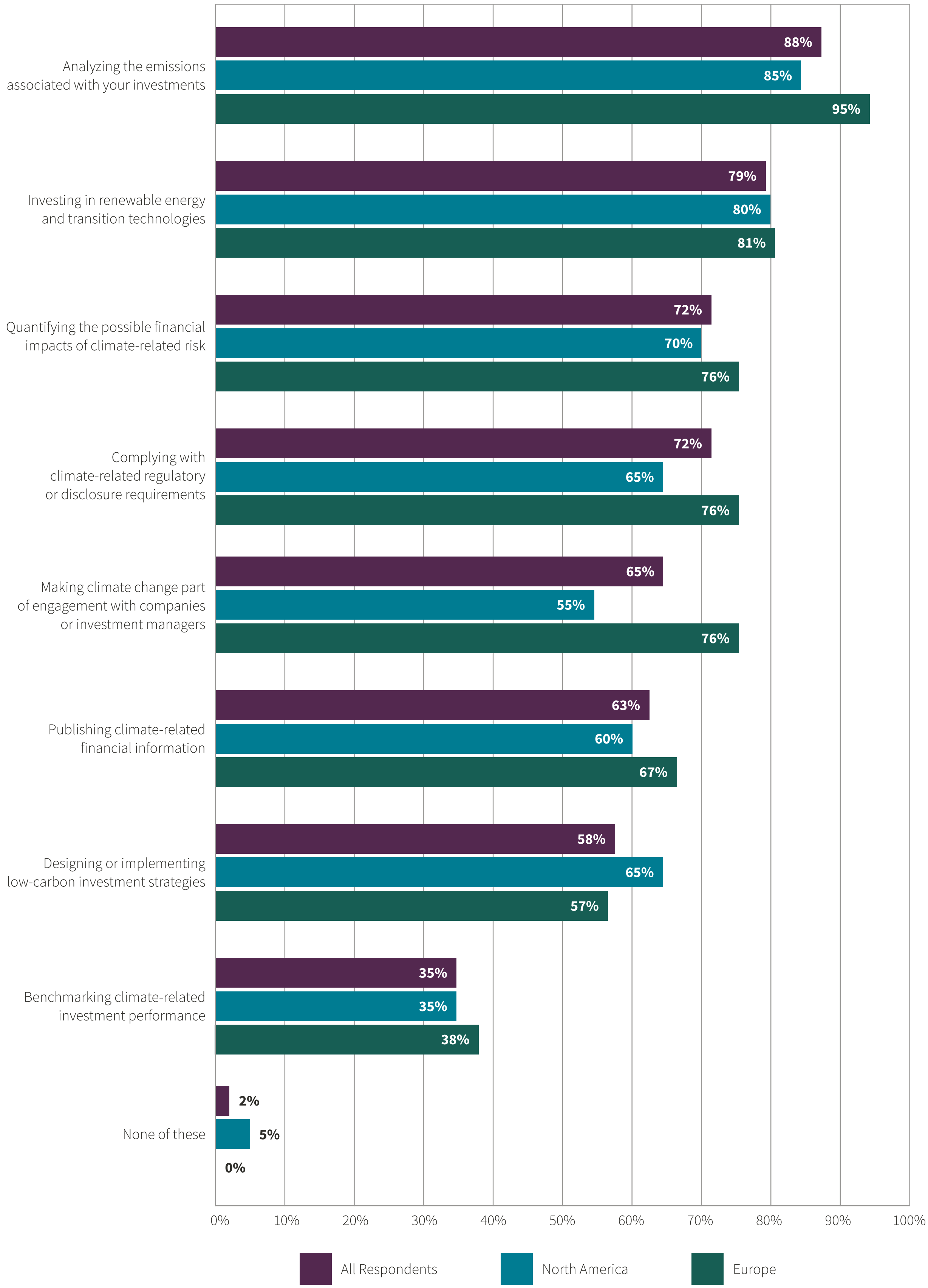


Do you believe that a company that might merit a high ESG score because of the nature of its core business or product should still be able to earn a low ESG score because of the negative way it manages other ESG factors?

ALL RESPONDENTS



Which of the following is your organization currently doing? (select all that apply)



METHODOLOGY

In fall 2023, Stanford Graduate School of Business, the Hoover Institution Working Group on Corporate Governance, and the Arthur and Toni Rembe Rock Center for Corporate Governance at Stanford University collaborated with the MSCI Sustainability Institute to survey major institutional investors and global asset owners to understand how they incorporate ESG factors into investment decisions. We received responses from 47 institutions primarily based in the United States and Europe. 43% of respondents have more than US $250 billion in assets under management; 34% have between $10 billion and $250 billion under management; and 23% have less than $10 billion under management. Approximately half of respondents operate under an ESG mandate that limits their investment choices based on ESG criteria. These respondents are primarily located in Europe.

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Brian Tayan is a member of the Corporate Governance Research Initiative at Stanford Graduate School of Business. He has written broadly on the subject of corporate governance, including boards of directors, succession planning, compensation, financial accounting, and shareholder relations. He is coauthor with David Larcker of the books *The Art and Practice of Corporate Governance*, *A Real Look at Real World Corporate Governance*, and *Corporate Governance Matters*.

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Linda-Eling Lee

Linda-Eling Lee is the founding director and head of the MSCI Sustainability Institute, as well as a leader in the field of sustainable finance.

She previously led global ESG and climate research at MSCI, where she built one of the world's top teams of analysts dedicated to understanding long-term drivers of sustainable value. Linda has authored multiple research papers on sustainable investing and twice been named by Barron's to its annual list of the Top 100 Women in Finance. She serves as a director of US SIF: Sustainable Investment Forum and is a fellow of the Finance Leaders Fellowship of the Aspen Global Leadership Network.

Linda joined MSCI in 2010 following the acquisition of RiskMetrics, where she led ESG ratings research and headed consumer sector analysis. She received her doctorate in organizational behavior from Harvard University, holds a master's from the University of Oxford, and has a bachelor's in East Asian Studies from Harvard College.

Full Bio: https://www.msci.com/who-we-are/our-leadership/linda-eling-lee

ABOUT US

Corporate Governance Research Initiative

The Corporate Governance Research Initiative at Stanford Graduate School of Business focuses on research to advance the intellectual understanding of corporate governance, both domestically and abroad. By collaborating with academics and practitioners from the public and private sectors, we seek to generate insights into critical issues and bridge the gap between theory and practice. Our research covers a broad range of topics that include executive compensation, board governance, CEO succession, and proxy voting.

Website: gsb.stanford.edu/cgri

The Rock Center for Corporate Governance

The Arthur and Toni Rembe Rock Center for Corporate Governance is a joint initiative of Stanford Law School and Stanford Graduate School of Business. The center was created to advance the understanding and practice of corporate governance in a cross-disciplinary environment where leading academics, business leaders, policymakers, practitioners, and regulators can meet and work together.

Website: rockcenter.stanford.edu

The Hoover Institution Working Group on Corporate Governance

The Hoover Institution Working Group on Corporate Governance brings together scholars, industry practitioners, and policymakers to engage in constructive and open debate about the logical consistency, treatment of evidence, and policy implications of proposed reforms to the regulatory systems that impact corporations. It also generates and disseminates research investigating the optimal conditions that allow corporations to sustain their crucial role in contributing to American economic growth and innovation.

Website: https://www.hoover.org/research-teams/corporate-governance-working-group

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