Illustration by Jarred Briggs

ESG Analyst Survey 2021: A world of opportunity

Foreword

We're very proud of our team of analysts at Fidelity. They are specialists in their fields, experts on sectors and, over time, they build an unparalleled understanding of companies and the people who run them. You may be familiar with this survey. Over the years it has built a reputation for accurately predicting trends in the business world from the bottom up, aggregating scores and peppering the data with insight direct from the analysts themselves. It has become a tool in its own right for our investors to use in their work on behalf of clients.

This quarter, for the first time, we have asked the 151 analysts who took part to focus exclusively on sustainable investing: the environmental, social and governance (ESG) topics which companies the world over are grappling with. The analysts quiz management teams on their ESG strategies as a matter of course, but also offer suggestions on how to improve those strategies and, ultimately, their performance.

So what does the survey reveal? Perhaps surprisingly, in an age of doom and gloom about sustainability, the analysts have spotted that some sectors are likely to profit from the changes required to halt global warming. They also tell us that while many companies report their ESG activities accurately, there are some that overpromote (or even underpromote) their efforts, highlighting the need for a global ESG standard. And, perhaps inspired by Fidelity's success in corralling support from fellow investors to campaign for stranded seafarers, our analysts report the growing power of collaboration in making changes in the world.

Sustainable investing is rapidly becoming, simply, investing. Our own research has proven that focusing on companies that perform well on ESG metrics leads to better returns for investors. A world of opportunities awaits, and I hope you find this report useful as you navigate it.

Richard Edgar
Editor in Chief

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Transition tailwinds power net zero opportunities

Undoing more than a century's reliance on fossil fuels is a considerable task but government policy, technological advances, and investor action are forcing change on our carbon-dependent way of life. This transition to a low-carbon world introduces risks of losses, of course. But our survey of Fidelity International analysts reveals that the path to net zero emissions now offers more opportunities for some sectors to profit than it presents threats to company balance sheets.

Key takeaways

- Fidelity International analysts believe that the opportunities arising from the low-carbon transition now outweigh the risks
- Many firms will need to raise emissions targets and increase investment to meet the goals of the Paris Agreement
- Companies can accelerate the transition by linking executive pay to emissions reductions and making their boards responsible for sustainability

Our first Analyst Survey focused on sustainable investing shows there are big differences between regions and sectors in their ambition around emissions reduction targets, and the investment required to achieve them. Many companies will also have to retrain staff in legacy industries and change their governance structures to align with international climate goals.

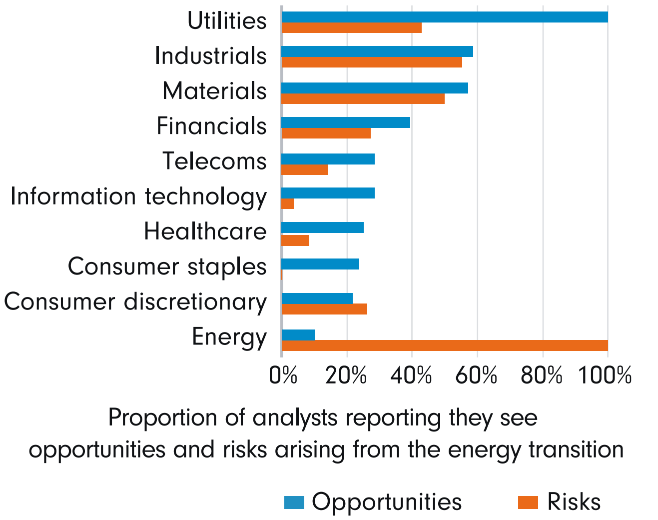
Opportunities and risks vary across sectors

Our analysts believe the utilities sector currently enjoys the best business opportunities, given the scale of investment being pumped into green energy. The transition could also lower the sector's business risks.

One fixed income analyst based in Europe says: "Utility companies will transition towards a greater proportion of renewable energy, secured under long-term contracts. From a credit perspective, this strengthens their credit profile and allows them to reduce their cost of debt as the leading companies will be perceived as safer investments."

Meanwhile, and perhaps unsurprisingly, energy companies face the biggest risks as fossil fuels are phased out, leaving them with stranded assets. In an extraordinary step, the International Energy Agency called on energy firms to stop all new oil and gas exploration from this year. Our analysts expect these sharp differences between the two sectors to diminish over time, as utility and energy firms blur together through mergers and acquisitions (M&A) into the clean powerhouses of the future.

Chart 1: There are opportunities in every sector from the energy transition



"How significant are the risks to your companies' current business models as a result of the transition to a low-carbon economy?" and "How significant are the potential business opportunities arising for your companies as a result of the transition to a low-carbon economy?" Scale of 1-7, where 1 is not significant and 7 is very significant. Chart shows the proportion answering 5-7 (there are risks and opportunities). Source: Fidelity ESG Analyst Survey 2021.

After utilities, industrials strike our team of analysts as having the brightest prospects from the transition, but with the second-highest level of risk. According to one Europe-based capital goods analyst, the subsector should benefit from increased demand for a range of products from renewable energy equipment and electric vehicle charging points to rail electrification machinery and hydrogen electrolysers.

The adoption of electric vehicles is already accelerating, driven by regulation, Covid-19 recovery packages, and consumer interest. Other areas like forestry and construction are capitalising on the growing appetite for wood-based substitutes for plastics. However, plenty of industrials face risks posed by regulation, supply chain disruption and legacy businesses. The same is true for materials like steel and cement, which are central to the transition but must decarbonise at huge cost along the way.

Information technology ranks in the middle of the pack, but some opportunities are emerging here as well. Software will become ever more essential to managing a grid powered by renewables and batteries, while general decarbonisation will require a host of new applications. One analyst points to a forthcoming carbon calculator from a leading German developer that will help companies capture and analyse their carbon footprints.

After utilities, industrials strike our team of analysts as having the brightest prospects from the transition.

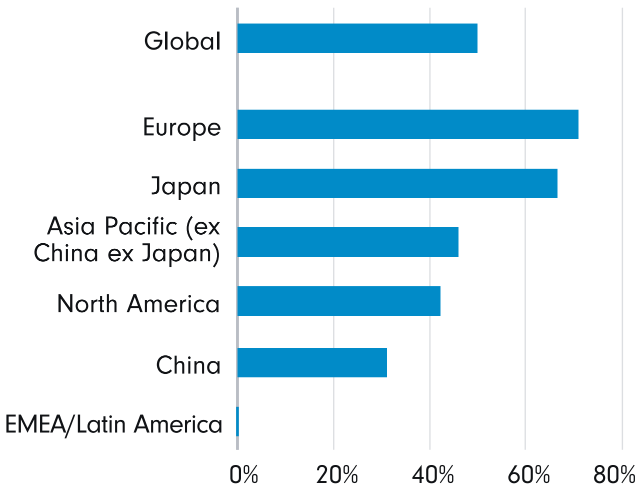
Consumer discretionary companies offer fewer opportunities and generally score lower on ambition and action throughout the survey. Our analysts say that much of the sector remains in 'survival mode' due to the pandemic and often has less reason to think about decarbonisation. Cruise liners and airlines are obvious exceptions. They too are focused on staying afloat amid Covid-19 travel restrictions but, as heavy emitters, cannot avoid the transition.

One Asia-based airlines analyst says: "Airlines cannot make promises on net zero yet, as they need a technological breakthrough in alternative fuels to get there. Hydrogen and battery power might enable domestic flights, but long-haul could have to rely on offsets."

More ambitious emissions targets are needed for some

While transition opportunities are on the rise, regional and sector variations between company emissions reduction targets are stark. For example, 71 per cent of analysts covering Europe believe companies have the right targets in place to get them to net zero by 2050, while the figure is zero for Latin America and Eastern Europe, the Middle East and Africa (EMEA). Globally, half of our analysts believe that firms will have to revise their targets upwards to achieve climate neutrality.

Chart 2: More ambitious emissions targets are needed for all to reach net zero by 2050



Proportion of analysts reporting they are confident their companies' emissions targets are ambitious enough to reach net zero by 2050

Question: "How confident are you that your companies' emissions targets are ambitious enough to meet net zero by 2050?" Scale of 1-7, where 1 is not confident at all and 7 is very confident. Charts show the proportion answering 5-7 (confident that targets are ambitious enough). Source: Fidelity ESG Analyst Survey 2021.

Around 85 per cent of utility analysts think their companies have ambitious enough emissions targets in place, while only 30 per cent of energy analysts and 26 per cent of consumer discretionary ones are as confident. Company proactivity in making the transition follows a similar patten across sectors, with utilities leading the way.

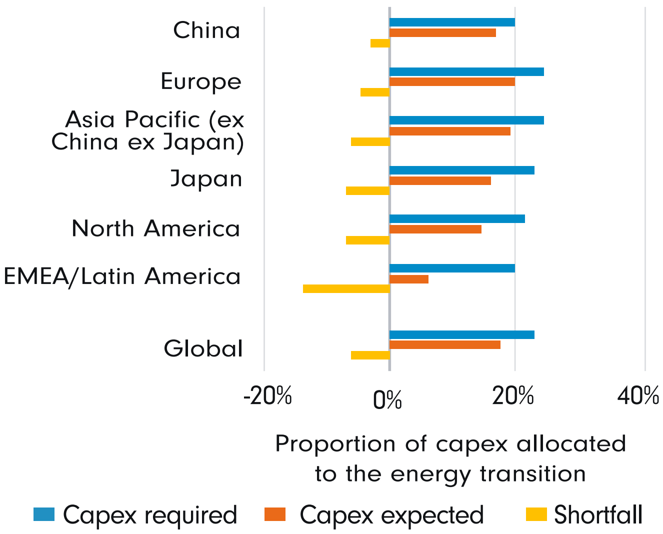
One Europe-focused utilities analyst says: "My companies are all actively building renewable generation technologies and trying to use as much renewable electricity as possible for their own consumption. They are highly incentivised to do this as the economics of renewable assets are now better than thermal, and regulation and investors are all very ESG-centric. Therefore, utilities have been very active in transitioning to a low-carbon economy."

Energy companies, meanwhile, are on the back foot. An energy analyst in North America says: "Companies are not setting emissions targets voluntarily; they're doing it because Wall Street demands it."

Globally, half of our analysts believe that firms will have to revise their targets upwards to achieve climate neutrality.

Only half of our analysts believe companies globally are making a big effort to help the transition, with considerable regional differences. Some countries are changing faster than others. Following President Xi's announcement last year that China would reach net zero by 2060, more companies are issuing emissions targets and increasing their transition-related investment. This helps explain why our analysts there believe companies have the least shortfall between the amount of capex they would need to allocate to the low-carbon transition over the next 12 months to meet the goals of the Paris Agreement and the amount they are actually expected to allocate.

Chart 3: Chinese companies are nearly spending what is required on the low-carbon transition



"What proportion of capex would your companies need to allocate to the energy transition over the next 12 months in order to be on track to meet the goals of the Paris Agreement?" and "What proportion of capex do you expect your companies will actually allocate to the energy transition over the next 12 months?" Source: Fidelity ESG Analyst Survey 2021.

One China-based analyst and portfolio manager observes: "Chinese companies tend to overinvest and they have cost advantage, so even if there's oversupply domestically they can export to other countries. For example, China is the biggest exporter of solar technology." As expected, EMEA and Latin America have the biggest shortfall, suggesting these countries will need more external help to make the transition in time.

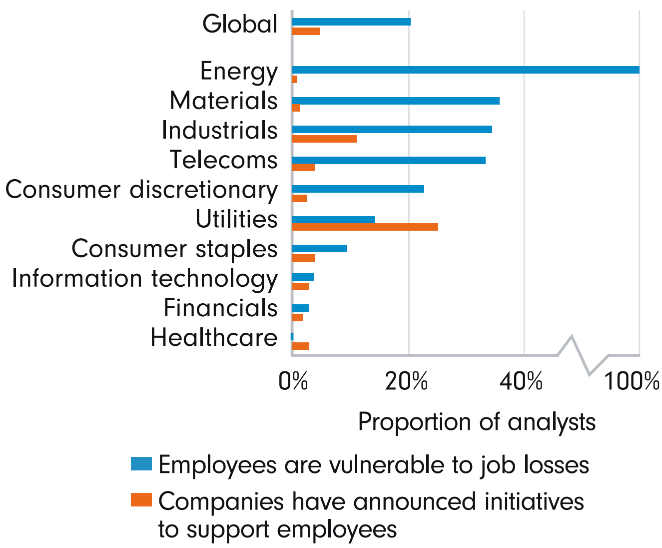
Supporting jobs and linking pay to emissions

The transition isn't just conceptual or limited to strategy. A fifth of analysts believe workers in their sectors could lose their jobs in a low-carbon economy. Some areas such as utilities are taking steps to tackle this. One utilities analyst covering North America says: "Companies that are closing coal-fired generation facilities have tried to provide employees with sufficient notice and relocation opportunities if possible."

Many industrials companies, too, have launched initiatives. A Europe-based autos analyst reports: "Companies are implementing early retirement schemes for workers making internal combustion engines (ICE) and their transmission mechanisms, or offering retraining. Also, negotiations with the unions often involve trade-offs. For example, a company might agree to close an ICE production line in return for hiring a number of software engineers."

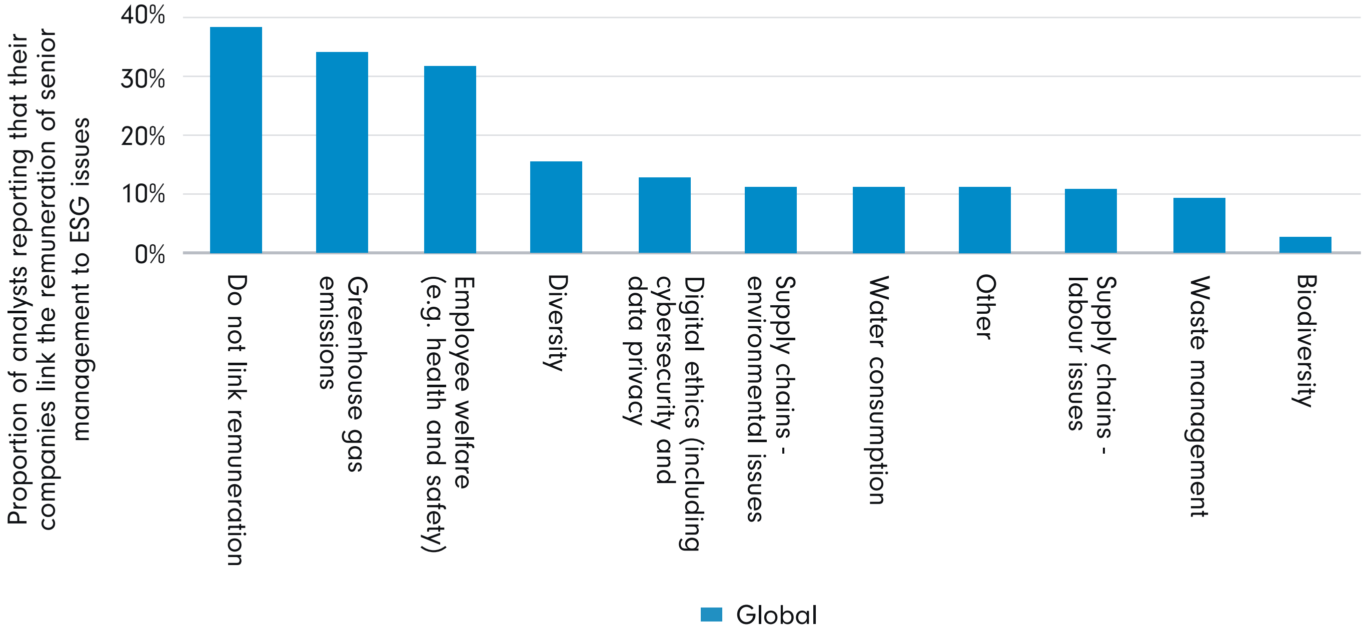
Disappointingly, sectors likely to be most affected by job losses from the transition, such as energy and materials, have yet to take meaningful action.

Chart 4: Employees most likely to be affected by job losses have received the least support



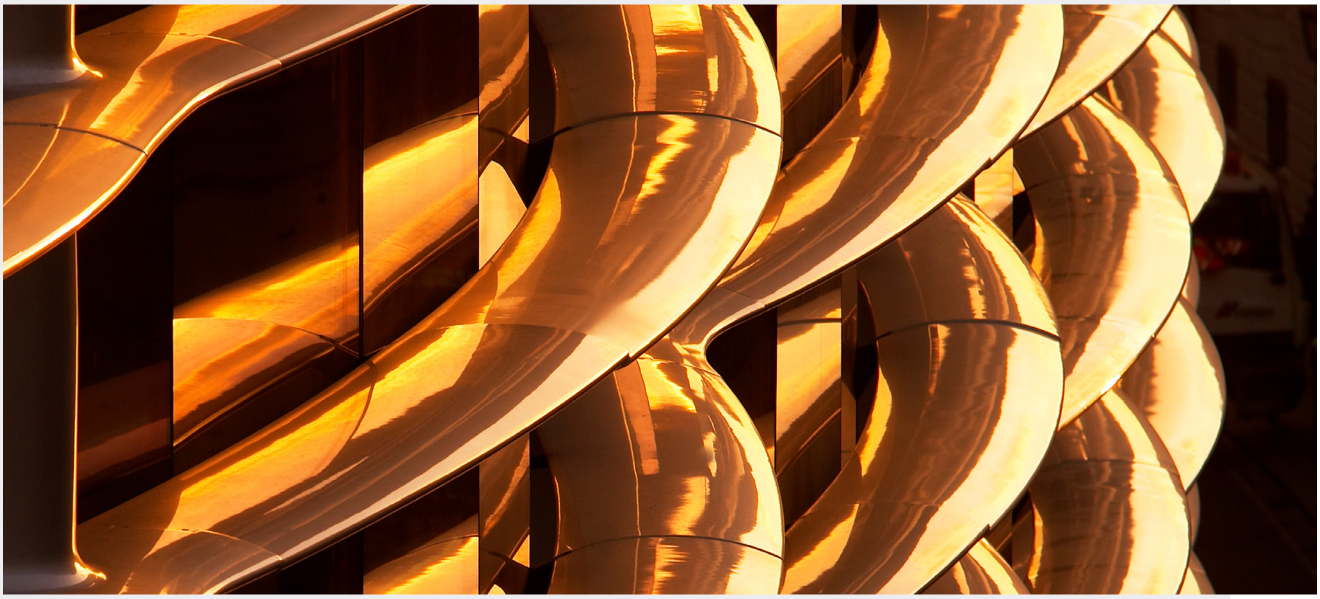
"How vulnerable are the employees in your sector to job losses over the next decade arising from the low-carbon transition?" Scale of 1-7, where 1 is not vulnerable and 7 is very vulnerable. Charts show the proportion answering 5-7 (vulnerable to job losses). And "What proportion of your companies have announced initiatives to support employees displaced by the move to a low-carbon economy over the next decade?" Source: Fidelity ESG Analyst Survey 2021.

Chart 5: Only around a third of companies link emissions to executive pay



"Do your companies currently link the remuneration of senior management to any of the following ESG issues?" Source: Fidelity ESG Analyst Survey 2021.

Companies can help accelerate the low-carbon transition by linking executive pay to reductions in greenhouse gas emissions. According to Fidelity analysts, only a third of companies currently do this, and only half require their boards to consider ESG issues more generally. The companies that do both should be well placed to capitalise on the immense range of opportunities that will arise as the global economy gravitates towards net zero industries, while mitigating the very real risks.



Office building facade made using energy efficient fibre-enforced polymer materials. (Credit: View pictures / Contributor, Getty Images)

Why we need a global ESG standard

As investors focus more on sustainable investing, some companies are tempted to oversell their ESG credentials. Fidelity International's ESG Analyst Survey 2021 reveals that, while many companies report their ESG activities accurately, significant numbers continue to overpromote their ESG performance. To get a true picture of each company's sustainability credentials, corporates and investors must adopt a consistent global standard of ESG definitions and characteristics. Several are in development, but none has yet been universally accepted; this must change.

Key takeaways

- Many companies report their true level of ESG activity, but some still oversell their ESG performance; a smaller proportion underpromotes its efforts
- Varying levels of disclosure makes it difficult for investors to allocate capital sustainably
- Introducing consistent global sustainability standards is central to addressing this issue

For some companies, as our analysts note in the adjacent quotes, words speak louder than actions on ESG matters; for others, the risk is that they are not promoting their ESG efforts enough. This inconsistency in reporting makes it harder for investors to allocate capital sustainably. Our analysts can dig into the real story on the ground, but only a common ESG standard can bring the kind of mass transparency that has been created by global financial accounting norms.

"They talk a good game but have been sanctioned by their largest customer for violations of labour laws."

"They present themselves as being 'A' rated despite having a public history of toxic discharge into local waters."

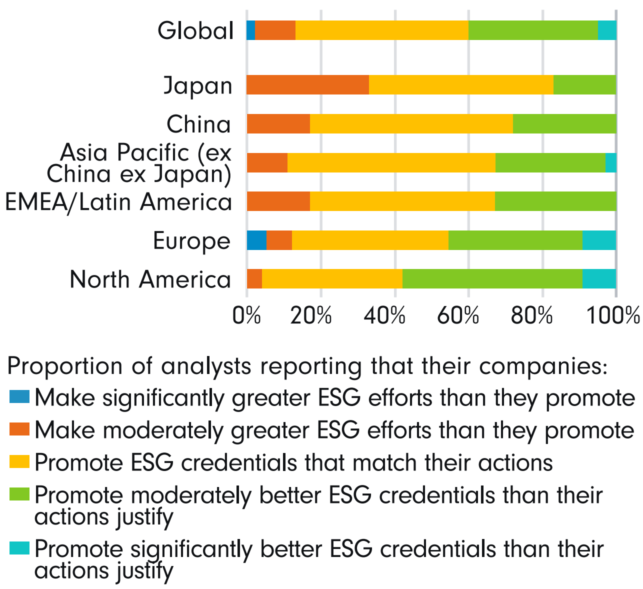
"Few less well-resourced companies really promote an ESG image, despite having policies in place."

ESG promotion varies across regions

In our first survey focused on sustainability, we asked analysts: "What do you think about your companies' efforts to promote their ESG credentials relative to their actions?" and gave them a scale of possible answers to capture whether companies tend to over or underpromote their efforts.

Overpromotion of ESG is often dubbed 'greenwashing' (i.e. when a company gives a misleading impression that its activities are environmentally sound). While the analysts reported some instances of this, as quoted above, their responses show they had a much broader set of behaviours in mind, including general differences in reporting approaches across regions, sectors and individual companies.

Chart 6: Corporate promotion of ESG activities varies markedly by region



"What do you think about your companies' efforts to promote their ESG credentials relative to their actions?" Source: Fidelity ESG Analyst Survey 2021.

North America has the highest proportion of Fidelity analysts reporting that companies tend to present their ESG efforts in the best possible light. According to one IT sector analyst, this manifests as "glossy ESG reports which cite large percentage changes in environmental metrics without giving context on whether they are material."

Some large US corporates have made ambitious statements that may take time to realise; for example, the US Business Roundtable commitment on corporate purpose made in 2019 or the big net zero pledges made in the last 12 months. However, the US government is expected to push for standardised ESG regulation, which should lead to more accurate reporting, especially in relation to carbon emissions.

More surprising perhaps is that nearly half of our analysts think companies overpromote their activities in Europe, the region considered to be the most forward-thinking on ESG. Often companies are doing well in some ESG areas, and say so, but overlook others where they are weaker.

One European financials analyst says: "Some large caps use resources to score highly on third-party ESG ratings without adopting a 'genuine' ESG belief set."

The need for an international standard

It is important to note that our analysts give relative scores in the survey for their own sectors and regions, so over-promotion of ESG in an advanced region like Europe may still be less in absolute terms than elsewhere. However, even on a relative basis, the findings show there is more work to do. The newly introduced EU regulations - Sustainable Finance Disclosure Regulation (SFDR) - are designed to ensure that sustainability is reported in a consistent way across the investment industry. SFDR is accompanied by a taxonomy that has strict criteria as to what is and is not viewed as sustainable. These developments should help improve European corporate ESG disclosure over time, but Europe will need to link up with Asia (including China, India, Singapore, and Australia) and the US to ensure companies really understand what they should be reporting to investors around the world.

Ned Salter, global head of investment research, says: "This survey data shows we must get behind a global ESG standard and collaborate across regions to ensure that companies are being transparent and consistent on sustainability and there is a direct link between what they say and the actions they take."

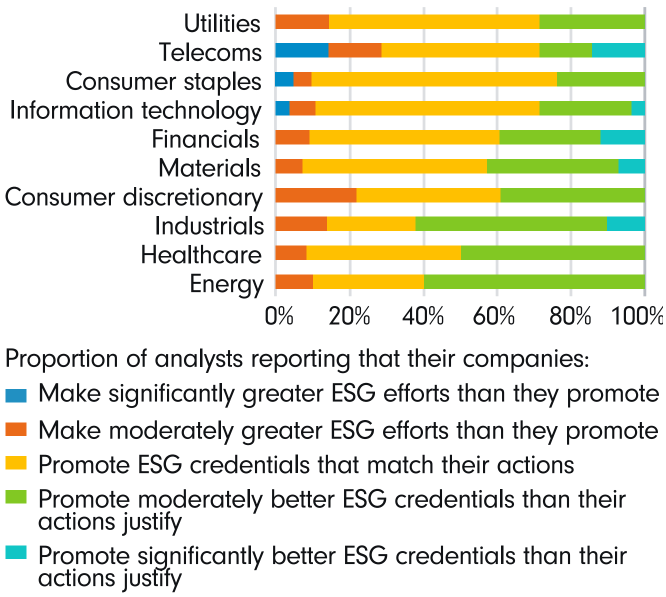
Several international ESG standards are being developed. These include the Sustainable Accounting Standards Board, the Sustainability Standards Board proposed by the IFRS and the Task Force for Climate-related Financial Disclosure (TCFD). So far, none has yet gained traction globally, but the survey highlights the urgency of narrowing these down to one or perhaps two widely accepted norms (similar to the IFRS and GAAP standards used for financial reporting). Until that happens, companies will continue to adopt different frameworks, do their own version of reporting, or not report at all. And investors will have to carry out their own in-depth research to understand what they are getting.

Some sectors have a greater incentive to talk about ESG

From a sector perspective, energy and industrials have the largest proportion of analysts who say companies talk up their ESG credentials. That is unsurprising given the pressure on these areas to show they are reducing emissions.

Less expected, perhaps, is that 50 per cent of healthcare analysts say their companies promote better ESG credentials than merited. "Most companies in the pharma space talk about improving access to healthcare but actions on drug pricing don't match those commitments," explains one healthcare analyst covering North America.

Chart 7: Certain sectors are prone to over and underpromotion



"What do you think about your companies' efforts to promote their ESG credentials relative to their actions?" Source: Fidelity ESG Analyst Survey 2021.

Companies that underpromote: Meet the greenblushers

At the other end of the spectrum from those companies that overpromote their ESG efforts are those that underpromote. We call these companies 'greenblushers'. That is not to suggest that they are actively concealing the great ESG work they are doing; they simply disclose less than they could. This may be due to the cost of reporting, the complexity of filling in third-party ESG rating paperwork, ESG promotion not being the norm among a peer group or within a culture, or because companies are not required to disclose their activities by local regulators. Greenblushing is most prevalent in Japan, followed by China and EMEA/Latam.

> Japanese banks have begun to make lots of improvements over the past 12-18 months.

An analyst who covers Japanese financials notes that historic perceptions of Japanese corporates have led to an under-appreciation of banks' activities on climate change. "Japanese banks have begun to make lots of improvements over the past 12-18 months, including tightening lending policies to coal-fired power plants, and two of the three major banks have published their first TCFD reports. However, these improvements are yet to be fully recognised by the market."

These perceptions should change as disclosure improves, and Fidelity regularly works with companies to help them understand the importance of ESG. As an example, we recently provided feedback to a mid-cap Japanese utility that had asked us to review its ESG report. We suggested it provide additional disclosure of its greenhouse gas emission reductions and other ESG activities to investors and ratings agencies. It agreed and improved its processes for quantifying and disclosing emissions. We upgraded the company two notches on our proprietary ESG scale, awarding it our highest rating. We expect its third-party rating will be raised in due course.

Companies like this can unilaterally improve their ESG disclosure and make themselves more attractive to investors. But the bigger picture is unlikely to change soon without wider cooperation between governments, regulators and investors to implement a universally recognised, credible and transparent system for ESG.

Many hands can make ESG work

Collaborative engagement by investors can be a more effective way to encourage ESG changes at companies, yet the practice is far from common.

Key takeaways

- Our survey of Fidelity International analysts suggests that collaborative engagements by investors can be more effective than one-to-one efforts
- But joint investor engagements are still relatively uncommon, suggesting there is room for collaborative efforts to accelerate
- Our analysts believe investor engagement is the most effective way to drive changes in corporate governance, while regulation is the biggest catalyst for change in environmental and social practices

Sometimes the whole is greater than the sum of its parts. Our survey of Fidelity International analysts suggests that joint efforts by investors on ESG issues can be more effective than traditional one-to-one approaches. This makes intuitive sense, yet collaborative efforts are still relatively uncommon in many sectors and regions, creating an opportunity which this survey highlights for more ESG investors to come together to drive corporate change.

Globally, about a third of Fidelity analysts think collaborative engagement has a bigger impact than solo efforts, while only 14 per cent believe that one-to-one dialogue is more effective. The remainder view the two approaches as equally useful depending on circumstances.

Collective engagements are more effective in some regions

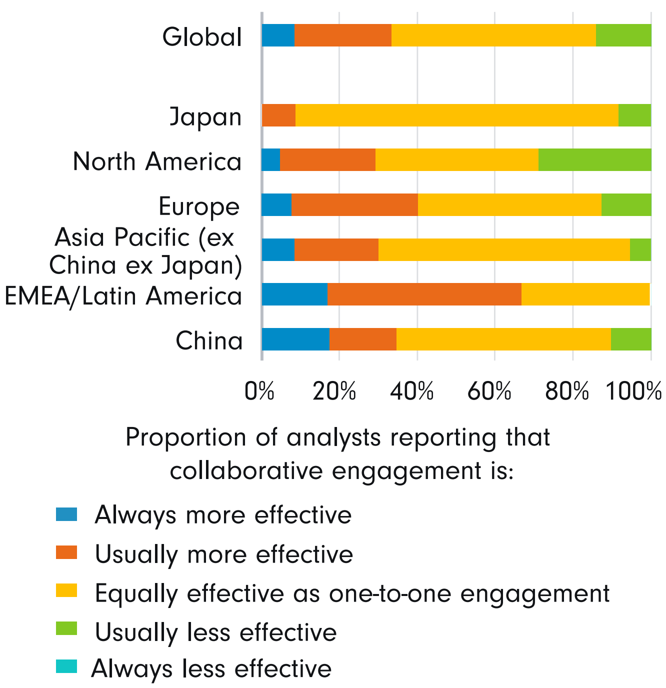
Our analysts say there are several factors that influence how effective each approach is, the most important of which is local practices and customs.

In Europe, collaborative engagement is viewed as relatively more effective because ESG is now part of mainstream investing, there are many activist organisations, and because ownership concentration can be high. One analyst who covers European stocks says: “Europe is not only tuned into ESG issues, but our team knows the senior management of European companies well and is plugged into the various industry bodies and regulatory systems. This helps us to be heard.”

North America and Japan are the only regions where collective action is not viewed as more effective, but even here it is still on a par with one-to-one interactions, meaning it pays to develop good relationships with management teams to build an understanding of which approach works best.

Our analysts who cover the US and Canada report that engagements often take the form of helping companies understand a different perspective rather than encouraging a specific action, so a personal approach can work better. One US healthcare analyst says: "ESG doesn't come up in group meetings or collaborative settings because fewer US investors are focused on it. So as one of the largest European investors that these domestic US businesses meet, we tend to have better ESG engagement in our one-to-one calls. That is changing though as US demand for ESG products grows."

Chart 8: Collaborative engagement is an opportunity for investors to drive change



"In your opinion, what is the better way to effect change in companies in your sector: collaborative engagement or one-to-one interactions?" Source: Fidelity ESG Analyst Survey 2021.

On the other hand, grouping together with other investors can help companies to focus on a particular issue. A US industrials analyst observes: "It can be a more powerful and consistent message to companies when a group of shareholders (or bondholders) all deliver the same message, rather than each talking about their own specific concerns. Many companies I talk to feel somewhat overwhelmed by the wide variety and volume of ESG questions they are fielding, so a collaborative approach may help them focus on the key points that matter."

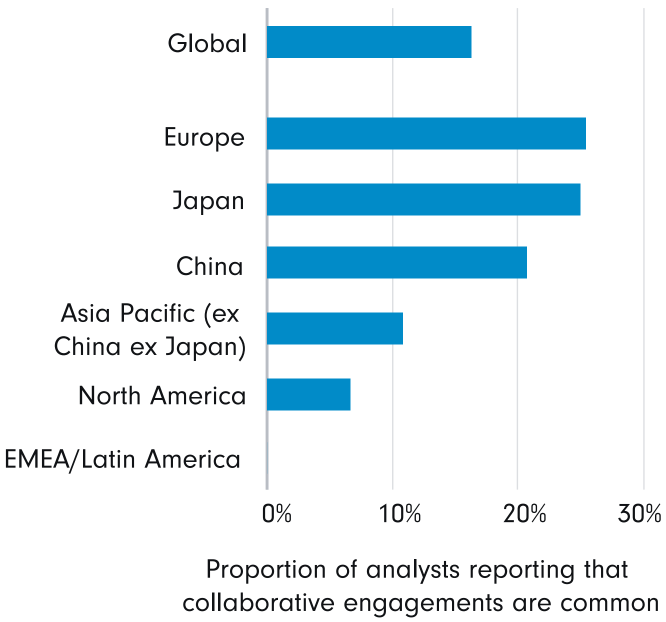
Japan, meanwhile, has a different regulatory structure for corporations than elsewhere, and companies still have a lot of crossholdings which can complicate investor discussions. Our fund managers believe Japanese corporate culture is changing fast, and shareholders are being listened to much more, especially during one-to-one engagements on governance.

However, as one fund manager puts it: "Japanese cultural norms mean that aggressive collaborative engagements can be viewed as threatening and could lead to the opposite outcome of what was intended. Domestic asset managers are also often subsidiaries of financial institutions, meaning working together may create conflicts of interest for them."

Room to grow

Despite signs that investor collaboration can amplify the impact of engagements, only 16 per cent of our analysts report that it is common in the sectors they cover, giving plenty of room for joint action to increase across all regions.

Chart 9: Despite their effectiveness, collaborative engagements are still relatively uncommon



"Based on your experience over the last 12 months, how common are collaborative engagements in your sector?" Please answer for investors in your sector as a whole, not just for your own engagements. Scale of 1-7, where 1 is not common and 7 is very common. Charts show the proportion answering 5-7 (collaborative engagements are common). Source: Fidelity ESG Analyst Survey 2021.

So why is collaborative engagement not more common? Historically, asset managers have been understandably wary of collaborating with each other for fear of revealing aspects of their investment approach to competitors or breaching compliance rules. Voting at the annual shareholder meetings of investee companies was typically handled by separate teams and was not under the direct oversight of portfolio managers and analysts.

However, the rise of ESG-focused investing has shifted attention towards growing the pie for all rather than simply trying to claim a larger share of a fixed pie. Analysts and managers now typically play a much more active role in voting decisions. Changing culture is hard though, especially as investors might have to work together for extended periods to push through ESG changes.

Recent examples of Fidelity's collaborative engagements include Climate Action 100+, a five-year investor-led programme to promote clean energy use among key greenhouse gas emitters, and Building Sustainable Protein Supply Chains, a multi-year investor campaign focused on the food production and retail industries.

The best ways to drive change in E, S and G

The survey also found that investor engagement is the most important driver for change in governance practices, while regulation is slightly more effective when it comes to environmental and social practices.

Governance changes are generally quicker to implement and easier to monitor than 'E' and 'S' factors. Speed is important because the length of time that equity and bondholders are invested in a company might be shorter than the time needed to make environmental and social changes. For example, splitting the roles of chief executive and chairman is easier to enact and measure than, say, changing the technology used in manufacturing.

A consumer discretionary analyst who covers North America sums it up: "It's not that engagement is ineffective per se for 'E' and 'S', but it takes longer to implement, is more nuanced and harder to measure, and takes more time to see the end result. Engagement remains important, but so does getting behind more regulated approaches for improvement."

Chart 10: Investor engagement is key to governance changes

"What do you think will drive changes in environmental/social/governance practices at your companies over the next 12 months?" Chart shows the proportion ranking each factor as one of the top three most important. Source: Fidelity ESG Analyst Survey 2021.

Nonetheless, investor engagement - whether collaborative or one-to-one - has an important role to play when it comes to propelling environmental and social change. Moreover, regulation and engagement are increasingly intertwined, because a company's compliance with regulations is often the measuring stick that investors use to evaluate environmental and, to a lesser degree, social factors.

An analyst covering European automakers notes: "Because of the huge cost of developing electric vehicles, carmakers desperately need to convince their investors of their compliance strategies in order to gain access to capital at a lower cost. Similarly, the risk of brand perception of a car company which consistently fails to comply with regulation is another way these sources of influence work in tandem. Thus, whilst regulation may be the dominant driver, in my experience, it works in combination with investor and consumer pressure."

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