ESG: BECOMING MAINSTREAM

Environmental, social responsibility and corporate governance criteria have become part of the investment process at leading asset managers as they engage with companies to improve governance and sustainability issues. Performance is improving as a result.

Mamadou-Abou Sarr
Northern Trust

"ESG is becoming mainstream."

Dirk Enderlein
Wellington Management

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BY HOWARD MOORE

"ESG is becoming mainstream," says Mamadou-Abou Sarr, global head of ESG at Northern Trust Asset Management. ESG is a framework of responsible and sustainable investing principles based on environmental, social and corporate governance criteria that is quickly being adopted by institutional investors. ESG principles are now being applied to inform the entire investment process, and doing well is indeed a result of doing good.

"Evidence shows that companies that have better ESG management tend to outperform in the long term, and they're more resilient during times of economic downturn," says Christina Zimmerman, manager of ESG research at Wellington Management. "We do this to get better risk-adjusted returns." At the same time, ESG analysis has become an opportunity to drive positive changes in labor relations, decarbonization, air quality, energy and water management, shareholder rights, management compensation and a host of other key areas.

Interest is growing rapidly, and investors are taking ESG factors into account more consistently to get a more complete view of the opportunities and risks of a company. "If you don't take it into account, you miss part of the puzzle when evaluating a company," says Edith Siermann, chief investment officer for fixed income at Robeco. Investors are becoming more aware of the potential opportunities and costs around regulation and consumer demand in relation to sustainability. "Every RFP [request for proposal] we receive has questions of ESG, and that was very different five years ago," she says.

Asset growth has been dramatic as an increasing number of institutional investors embrace ESG. In 2012 professionally managed assets devoted to ESG principles, through funds and other vehicles, was $13.3 trillion, according to the Global Sustainable Investment Alliance. By the end of 2014, it had reached $21.4 trillion, a growth rate of 61 percent in two years. Assets over the past five years have tripled. "Asset owners are driving the trend," says Sarr. "An increasing number of asset owners are defining and enforcing ESG policies in their investment guidelines." Those that aren't are usually embracing ESG on a best-practices basis.

"While the perception is that there is greater ESG integration among European asset owners, over the past two years the fastest-growing region to adopt has been the U.S.," Sarr says. There is more awareness among Millennials who want retirement or other portfolios that are mindful of ESG issues. In European markets ESG has been an ongoing theme, and there's a stronger regulatory framework in place. There is a smaller asset base in Asia, where ESG is in early stages and driven by Australia and New Zealand; however, China is likely to become a key player in the ESG field. "While many companies in emerging markets, which often have high levels of sovereign or majority shareholder ownership, do not put best ESG practices in place, there are some examples of leapfrogging," he says. Under the

Five Questions CIOs Should Ask Investment Managers About ESG

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As risk management has garnered more attention in recent years, institutional investors who have integrated environmental, social, and corporate governance (ESG) considerations into their process have put themselves in a better position to assess risks and opportunities in their portfolios. In our view, keeping track of how companies handle ESG issues is an alpha tool that also performs an important risk function — and we have found it to be a powerful early warning system.

We recommend asking investment managers these five questions to learn more about their ESG approach.

1. **What is your philosophy for integrating ESG risks within your investment process for all asset classes, both from a risk-management and return-enhancing perspective?**
2. **How do your portfolio managers engage with company management teams and offer best practices on ESG issues?**
3. **Do you have access to ESG data (such as company safety records, waste disposal practices, and executive compensation), and do you have experts capable of interpreting the impact of these risks on your portfolios?**
4. **How often do you exercise your right as a shareholder to vote proxies and voice concerns to influence companies to change their corporate behavior?**
5. **Are you a signatory to the United Nations Principles for Responsible Investment (PRI), and do you actively promote these best practices?**

Investment managers who engage with companies on ESG issues may have a deeper understanding of managements' perspectives and be better able to incorporate these findings into their investment analysis. While investors can learn a great deal about companies from external sources, direct engagement allows them to better appreciate the nuances of a company's ESG risks and opportunities. For example, if a company appears to be struggling with significant ESG issues, it's important to recognize exactly what those issues are, how they might negatively affect investment results in the short or long term, and how those risks can be reduced. If a company is particularly good at managing ESG issues, more can be learned about their best practices and the opportunity for positive performance.

Additionally, company management teams can seek feedback on their issues of concern. It's a two-way process that allows companies and shareholders continual opportunities for improvement, and that can provide portfolio teams with actionable ideas to incorporate in their investment decisions.

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Increasingly, we find that ESG issues have a quantifiable impact on the performance of the companies that we invest in. Recent examples include:

- **Environmental:** A food and beverage company reported saving US$15 million per year* by improving water efficiency.
- **Social:** An Asian automobile manufacturer expects to spend over US$300 million* on product recalls due to safety issues.
- **Corporate governance:** An oil and gas company recognized a nearly US$2 billion* loss due to acts of corruption.

Given the impact that issues like these can have on financial performance, we recommend that CIOs and other institutional investors partner with their investment managers to comprehensively integrate ESG analysis into the investment process.

**Data sourced from specific company reports.*

Wellington Management's ESG Team

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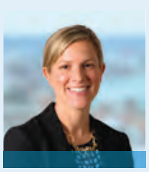
ESG Analyst



Hillary Flynn
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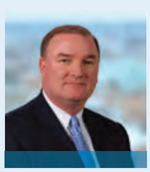

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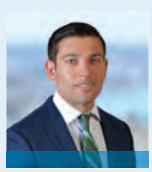

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To learn more about ESG integration and engagement at Wellington Management, ***visit: www.wellington.com/ESG***

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Sustainable Stock Exchanges Initiative, ESG disclosures are required in Brazil and South Africa before an exchange listing, and the corporate culture is changing in those markets.

Indeed, asset managers and asset owners are key in driving this change, and there's a growing recognition that a consideration of ESG issues is part of an asset manager's fiduciary duty. "If you are an asset manager, you hold these shares on behalf of your client and it's your duty to be an active owner," says Wellington Management's Zimmerman. When members of Wellington's ESG team speak with corporate management teams, they ask pointed questions about executive compensation, board structure, governance, environmental policy, labor standards and other sensitive issues. "It's a two-way dialogue: They give us best practices and insights into their strategies and rationales, and we give them feedback," she says. "We want companies that have poor ESG practices to improve." The alternative could be to divest, which has not always proved to be effective in driving change. "In general, engaging them on these issues has worked best," she says.

The main three drivers pushing ESG forward are regulation, asset owner policy and sustainability as an investment theme. "The regulatory framework, especially in Europe, is pushing the ESG agenda and encouraging more asset owners to integrate guidelines that are laws anyway," says Sarr. For example, last year the Netherlands banned the investment of public pension funds in companies that produce cluster munitions. In the U.K. more than a dozen local authority funds are developing a national procurement framework based on ESG principles. "There is also pull coming from asset owners themselves, especially in the Nordic countries," he says. "It's not by law but, for example, the Swedish pension fund AP4 and others are leading the agenda because they believe there is a materiality attached to climate change risk." The third driver is the view that integrating sustainability has a marked impact on performance, and there is more research that shows that companies that are mindful of ESG issues tend to do better in the medium and long terms. "We've seen a focus on corporate governance in emerging markets, an interest in climate change risk across asset classes and a growing interest in renewable energies," he says.

There are many examples of poor corporate governance resulting in an environmental, accounting or corruption scandal that has a significant impact on portfolio returns, as the world has seen in recent automobile company scandals. "These are a matter of corporate culture and are at the very heart of ESG," says Dirk Enderlein, director of Wellington Management's European equity strategy. "You have to ask, What culture did they create that made this possible?" The environmental and social issues are linked to corporate governance. "If you don't have good corporate governance, you usually won't have good environmental management practices, employee standards and supply-chain risk management," Zimmerman says.

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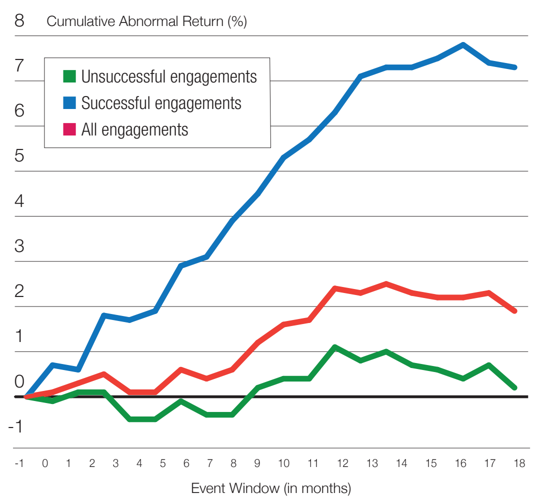
Better Performance Follows Successful ESG Engagements



Past performance is not a guarantee of future results. Source: Credit Suisse, *Credit Suisse Global Investment Returns Yearbook 2015*, Dimson, Marsh and Staunton, p.25; and Elroy Dimson, Oğuzhan Karakaş and Xi Li, "Active ownership," *Review of Financial Studies*, Forthcoming, 2015. Fama-French size decile returns from Professor French's web site, http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/.

of investor and counterparty services at Wellington Management. "Before we invest we want to make sure there's an alignment of short- and long-term interests between the company and our clients." A lot of information can be gleaned by analyzing the compensation structure, management incentives, board member independence and active engagement, and policies around risk management, cybersecurity and labor. "We did some analysis on a large company and discovered its suppliers had pretty bad cases of child labor on farms," says Enderlein. "This lowered its score quite dramatically." The company reacted quickly by starting a random test program for the farms from which it sources. "You can see a company's culture reflected in the time it takes to react," he says. If the company doesn't react at all, it's a red flag, and there is probably more to be concerned about. "By engaging with and talking to these companies, we get a sense of their approach, which is important in understanding a company's aggregate value, and encouraging them to embrace ESG principles seems to be bearing some fruit in terms of returns," says McCarthy.

However, there can be some confusion over integrating ESG principles into the investment process. "Some question whether there is a performance cost," says Robeco's Siermann. Some investors, particularly in the U.S., contend that ESG is not part of their fiduciary duty. "But that depends on which approach you take," she says. The financial approach to ESG analyzes factors that have an impact on risk and potential returns. "This means that you make ESG analysis an ingredient of your normal investment process whereby you broaden your base of information," she says. The confusion comes from viewing ESG from an ethical standpoint and eliminating stocks based on philosophical beliefs. "That approach negatively affects performance," she says. ■