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ESG and sustainable finance

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The business case for ESG in institutional investment

The RI/MSCI round table debate

Martina Macpherson, Zach Oleksiuk, Bruce Kahn, Bill Mills, Tom Kuh, Gerard van Baar, Marcel Jeucken, Mariela Vargova, Rob Lake, Roger Urwin, Erika Karp, Andreas Hoepner, Noel Friedman, John Phillips, Sarah Cleveland, Chris McKnett, Linda-Eling Lee

Part 2: ESG: current practices, future prospects

Roundtable Concept and Moderation:

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John Phillips, *Senior Portfolio Manager, Chairman of RI Committee,* **AllianceBernstein**

Sarah Cleveland, *Founder & CEO,* **Sarah Cleveland Consulting**

Chris McKnett, *Vice President, Head of ESG,* **State Street Global Advisors**

Tom Kuh, *Executive Director,* **MSCI ESG Research**

Linda-Eling Lee, *Executive Director, Global Head of ESG Ratings Research,* **MSCI**

Hugh Wheelan: I'd like to start by asking some of the asset managers how they have developed their ESG strategies internally?

Responsible investment . . . works differently in the short and long term and across different asset classes

Marcel Jeucken: On the materiality side, PGGM started this journey in 2005 by laying down five investment beliefs. One is that "responsible investment pays off," but that it works differently in the short and long term and across different asset classes in different ways, of course. In the short term if information is not material, say in equity portfolios, you don't integrate it into investment decisions, but you keep an eye on it. If your investment horizon is longer, say in real estate, private equity or infrastructure, where you might invest for 10 to 15 years, then you have to understand what the world is going to look like. i.e. how governments and businesses are going to respond to society's needs, and how customers are going to react. Take real estate, you have to make sure your buildings meet environmental standards to be able to sell them. That can be costly, and its something you should look at when you buy and develop property.

Asset owners have got liabilities for 50, 60, 70 years so they have to understand what the world is going to look like in the future, which also means understanding their own role as an influential group of asset owners that can help frame the world for sustainable finance. This is a much bigger question of universal ownership (owning the whole market) with long-term liabilities.

Hugh Wheelan: Zach and John, I'd like to bring you in. How do these issues resonate at large fund managers like BlackRock and AllianceBernstein?

John Phillips: AllianceBernstein is a mainstream investment manager so we have a fiduciary responsibility to maximize returns. We recognize that ESG issues can have an impact on investment returns. We are a recent signer of the UNPRI, as of November

1st, 2011. What I've done over the last couple of months, and will continue to do, is meet with our 20+ investment teams across equities, fixed income, and alternatives. I've sought to make clear to them the commitment that they have, as a result of the firm's commitment, to actually make this a reality in their day-to-day investment research and decisions. Our approach is to integrate ESG so that it is the role of hundreds of people, because we have many analysts, portfolio managers, and CIOs. The goal is to integrate ESG within investment research and decision-making and have the investment teams provide their own examples.

Hugh Wheelan: How hard is this for asset managers who are held to short-term performance to integrate ESG into stock selection decisions? It's taken a certain amount of time for some big managers to sign the PRI. Are they serious, or are they just seeing the way the client wind is blowing?

Martina Macpherson: There has long been a debate between those who regard ESG factors as being risk factors which can have a material impact on investment performance - and those who regard them as exclusive social issues. However, the evidence of materiality of ESG factors is now really beginning to take shape as practitioners are mandating and integrating ESG - and excellent academic research has emerged in this field.
However, material ESG issues vary by industry sector. This is because the impacts that companies have are associated with the type of industry activity and their core business models. All businesses use resources and have environmental and social impacts—the translation of those impacts into industry specific terms is what makes them useful, actionable and measurable, by companies and by investors.
Understanding the relevant sustainability issues by industry provides a way to benchmark performance of investments and also provides a constructive platform for dialogue with portfolio companies. Improving performance on key ESG issues can help to mitigate risk and unlock value for shareholders.
Hence, it is a component of fiduciary duty to understand and evaluate material ESG risks and opportunities for each industry and asset class.
Looking at 'materiality', we could then also include the following question:
- Can ESG factors make a material difference to the risk/return profile of portfolios - and how?

John Phillips: There are so many investment time horizons for investors and managers. The UNPRI does ask for increasingly rigorous reporting, so it's in the best interests of signers to be very serious about their responsibilities. In the case of a passive equities manager, I think the ESG obligation could be fulfilled within appropriate proxy voting. Considerations of ESG in stock selection do not apply, unless they are using investment restrictions. I

Good governance and good stewardship of assets can contribute to long-term value

agree that for a very short-term investor, ESG considerations could play a smaller role. A purely quant or a purely passive manager may not have developed their own proxy voting resources and may be more likely to rely on a proxy voting service. From the point of a fundamentally oriented firm, I think it is intuitive and common sense to take a long-term view though.

Zach Oleksiuk: We believe that good governance and good stewardship of assets can contribute to long-term value, and we have a fiduciary duty to act in our clients' interests at all times. The most common engagement activity that our team conducts is still proxy

voting, which we supplement in many cases with ongoing discussions with companies aimed at building mutual understanding. The alternative is to build out your in-house specialist group for proxy voting and engagement, which, by the way, we do on behalf of our large set of index funds.

Our engagement activities are meant to share our ideas, and to understand where companies are coming from, and to effect change if we think that there is a problem. A lot of companies are, frankly, surprised to hear that BlackRock cares about a certain supply chain issue. They might see it as a social issue while we see it as an economic issue.

Sarah Cleveland: The differences between shareholders are major. In my experience as an investment consultant, working with smaller investors, say $100 million and even to multi-billion dollar funds, the investment committees have little clue what's in the portfolio. The consultant shows them the top 10 stocks, and there isn't any discussion about the companies; whether it's a passive or active portfolio, it's pretty much the same. However, I've just started as an investment committee member for a private family foundation and I'm sitting on the other side of the table, so to speak. They have an environmental mission and they want to do more ESG integration and really look at their investments. But, I was struck at my first committee meeting, that there was absolutely no information on the managers. I was just given a list of products. We can't underestimate the basics that we need to get under our belts as well.

Some asset owners are just totally overwhelmed by this stuff and not equipped at all. They don't know where to begin, especially when their consultant has never really addressed many of these issues.

Rob Lake: I'd like to ask the asset managers around the table, what kinds of signals and messages they are getting from clients? Is there actually detectible client pressure?

Chris McKnett: From clients in the Netherlands it's been an area of longstanding interest, and in Australia also. US clients have become much more aware of the issues, but they are largely agnostic.

Erika Karp: I actually think some of the most brilliant investors in the world already are doing this. I think there are massive numbers of closeted sustainability investors out there. They don't talk about it. They may simply not be labeling it this way. And they may not be doing it systematically. But there are investors out-performing even in today's markets where you have an unprecedented correlation in assets and I think some are pursuing ESG strategies. Some are consciously not using the terminology because they don't want to be pigeonholed.

I think a lot of people are already doing some form of ESG risk analysis in private equity

Linda-Eling Lee: I think a lot of people are already doing some form of ESG risk analysis in private equity. It's partly because of the level of due diligence that you're able to perform on a single company. Coming back to the question of materiality, one thing I wanted to add is that whenever there is some regulation or policy change being discussed, something will likely happen down the road, we just don't know when. You don't need to have a position, for example, on hydraulic fracturing to know that there will be more regulation somewhere down the

road, which will directly impact operational costs and could generate major liabilities. We may not have the specific timeframe for it, and we don't know the exact size of that future cost just yet, but that does not matter for understanding that some companies are better positioned for those eventual downsides than others.

Hugh Wheelan: Is the business model viable enough to be able to invest in better research?

Linda-Eling Lee: Part of the problem, I think, is that a lot of the research in mainstream financial analysis starts by looking at industry drivers and then tries to figure out whether or not a company's business model is going to win or lose based on those drivers. In contrast, a lot of ESG analysis looks at specific ESG factors and assumes that a specific factor matters for all companies across the board. I think this discrepancy between the two approaches raises the barrier to integrating ESG research. I think it's much easier for investors and analysts if ESG research can be more integrated into the way investment processes already currently exist, i.e. to start at the industry level and then to look at specific drivers of industry risk and returns. Then add the extra layer of longer-term, potential problems these companies could face if they're not able to anticipate and manage these risks.

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Erika Karp: Hugh, you asked about the business model. As has been suggested, I think partnering with analysts and portfolio managers to elevate their knowledge on ESG issues, change their lens and get them to ask different questions on the companies and industries where they're so expert already, is the way that real change will happen.

Rob Lake: Or, is the reality, Erika, that fund managers get rid of the SRI team, take on an external ESG research provider and then hand it over to a couple of portfolio managers and say: "That's ESG integration for you." The analogy that I always use when this issue comes up is that we still have, well most investment institutions still have, a team of economists, or people whose job title includes 'economist'. Which doesn't mean that you don't expect your in-house portfolio managers and analysts to know a little bit about economics on a good day. So, there's probably a place for someone who knows more about the issues in the institution than everybody else. But clearly more people in financial firms need to know more than they currently do. So, huge, centralized ESG teams are probably not the way to

go. But an elite cadre of specialists spreading their tentacles throughout the shop as John seems to be doing sounds pretty sensible.

Chris McKnett: Rob you asked about client signals earlier. One thing we clearly see at SSgA is good breadth to current market signals across client segments and across markets. But within those markets and within those client segments, there's not a lot of depth. It's top-heavy, meaning that you've got big actors who are very influential, and then a very long tail on the left-hand side

The pressure is on us to come up with a systematic way to integrate ESG factors into our investment decision-making

that's not doing much. The signals are coming through in the aggregate, but they don't weave together into a very clear narrative. But, directionally, it's very clear to us where this is heading. If you think about ESG demands and pressures from asset owners and consultants on us as a manager and you chart it, it's moving up and to the right very steadily. We, and a lot of the market like to think of ESG and sustainability as a product approach: i.e. you build something, you think it works, you put it into a strategy, you sell it. That can still be done. But what I refer to as the inconvenient truth of ESG, is that the pressure is on us to come up with a systematic way to integrate ESG factors into our investment decision-making and stewardship of assets. The reason it's inconvenient is that it's more about revenue retention, rather than a monetized investment strategy. And that's a long build-up for a $1.8 trillion manager with a quant and beta focus, because it requires a combination of internal and externally sourced information and data.

Hugh Wheelan: I'd like to ask our panelists to reflect on the discussion they've heard and start looking ahead a bit to what the future might hold, say out to 2015? Roger, could you give us your thoughts about what you've heard?

Roger Urwin: The paradox to me is that very few asset owners and investment board members and trustees could stay with this conversation. It really has profound significance, is financially driven and is significantly material. But, the way that we actually run the investment chain is the convenient – Plan A - way, via benchmarks and one-year plans of thinking these issues through. In addition, many asset owners are currently beset with solvency pressures and so they're quite comfortable thinking with a Plan A, which assumes business as usual, which is investment and monitoring against a one-year time frame. But there is a Plan B, which is doing two things well: the present and the anticipation of the future. This is the

idea that we should be investing as though we understand and make some allowance for the transformations that are likely in the future. We should be mindful of all those new prices materializing in tomorrow's economy; of externalities becoming internalized costs. Those are the sorts of issues where asset owners are not getting a mandate through to the asset managers. As a result, in my observation, the reaction of asset

managers and PRI signatories, is actually: “fine principles but show me the action.” It isn’t so obvious to many people that ESG is a material influence and the experts in this room aren’t necessarily getting their influence through to the whole investment process. Currently, the relationship between portfolio managers and experts in sustainability is limited and not well integrated. That said, I do think

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there is a fantastically upbeat part of the conversation. The trajectory of change I experience most of the time is actually relatively flat. But there are some leading funds that are universal owners, i.e. big investors that own a slice of everything in the market, who are starting to articulate investment strategies that are to do with capital being applied in a different, more sustainable, long-term manner. This could become self-fulfilling and knock on into prices when more asset owners genuinely attempt to do integrated ESG. This will only come about with better measurement. The merits of integrated ESG are very difficult to measure. And when things are not measured, they don’t get respect.

Bill Mills: I think if we’re truly going to move into long-term investment then corporate engagement is going to become massively important. We need the ability to lay out a corporate engagement plan and convey that to fiduciaries in an easy, understandable fashion, with benchmarks and hurdles. If you’re a long-term investor in a corporation, and you’re engaging with

the corporation’s management you ought to have confidence in the DNA of that corporation. And you ought to be able to explain those things to fiduciaries much easier than by talking about ineffective Sharpe Ratios… no disrespect.

John Phillips: I wanted to say something about corporations themselves. We’ve talked about asset owners and investment managers. But as someone who’s engaged with many corporations, I know there’s a vast difference in the ability of corporations to engage. The really interesting recent HBS paper referred to earlier by Eccles and Serafeim found that only half of the 90 most sustainably oriented companies in the US, by their definition, had a board-level commitment to sustainability, and only a third of those 90 companies had clear links between sustainability and senior executive compensation. So, we are in a very nascent stage with regard to corporate sustainability. But I think that will improve rapidly, and I think that the companies that are greenwashing will clearly be discovered. We also need to move toward some kind of ‘ sustainability assurance’ as well. We don’t yet have accounting standards or audits for sustainability, but several groups are working to develop them.

We'll know we've done our jobs when the distinction between ESG and mainstream financial research is meaningless

Tom Kuh: I think that to get the kinds of standards you're talking about in an industry that really is in development, there needs to be policy in place that mandates the reporting of information that analysts can then use. We'll know we've done our jobs when the distinction between ESG and mainstream financial research is meaningless; when the standard for good financial analysis involves, at a very fundamental level, integration of ESG factors. The step preceding that is going to be the standardization of the information used, so that you get meaningful, comparable information into analysts' hands.

Rob Lake: What I hope we'll see by 2015 is stronger, more sophisticated and penetrating signals coming down through the investment chain. Don't misinterpret what I'm about to say, but I also hope people will move beyond simply asking their asset managers whether they are PRI signatories, to asking slightly more probing, meaningful and enlightening questions about the nature of the investment processes that the managers aspire to run for them. I also hope investors will start to incorporate the basic questions that tend not to get asked at the moment on stock examples: For example: "Talk me through your investment positioning at the time of the Gulf of Mexico explosion." Or: "How can you explain your overweight in BP at the time?" Hopefully we'll also see more questions being asked about things like portfolio turnover and its meaning in the context of long-term visions and views. Maybe we will also see long-term training as part of the mission of asset owners, which is then reflected in the way they look at other asset classes like hedge funds, quant strategies and high-frequency trading. What can corporations realistically do in response to enlightened long-term investors if the short-term investments coming from the overwhelming bulk of the market are pushing in the opposite direction? Companies see their share register changing all the time and hear people saying "Short-term, short-term, short-term" on profits. Then they have a small number of people coming to them saying: "Well, I've got this mandate from these enlightened asset owners telling me that I should tell you to be long-term." However, from the broader perspective of a healthy, functioning economy with corporations that deliver financial returns in the long-term that long-term asset owners need, we've got to think through these issues.

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Andreas Hoepner: It's quite interesting to see how conventional finance deals with predictions. Few people predicted Twitter or the Arab Spring, and when you look back, predictions seem, on average, to be getting worse by the year because the world's getting more complex and much quicker. Within weeks now, you can have a serious problem on Facebook because millions of people don't like you. Twitter is quicker than any conventional journalist in many cases because it's a direct source to the consumer. So there are many intangibles coming to market. Therefore, I would presume there's a lot of opportunity for certain types of ESG investment.

Sarah Cleveland: One comment about asset owners. I don't see corporate pension plans in the US taking this up by 2015. I think there is a significant move, however, on the foundation side and amongst high-net-worth and family offices. There's a lot of interest in impact investing, and understanding what's in your portfolio.

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