MSCI
ESG Research

Research Insight

Integrating ESG into the Investment Process

- From Aspiration to Effective Implementation

Remy Briand, Roger Urwin and Chin Ping Chia

August 2011

Introduction

In recent years, many institutional investors have been increasingly recognizing that the long-term sustainability of their investments matters. Environmental, Social and Governance (ESG) factors are becoming important considerations for investors to focus on given their influence on a portfolio's risk and return profile. Some asset owners are starting to embrace the concept of "Universal Ownership[1]" where they see the long-term exposure to the whole economy through their portfolio as requiring specific investment actions. In particular, they see externalities generated by companies as an integral part of the risk and returns of their investment portfolios. Mitigating risks due to exposure to ESG factors and dealing with externalities in order to produce higher sustainable long-term returns has become an integrated part of the portfolio management process for many investors/asset owners.

For asset owners, integration of ESG factors into the investment process helps to address the disconnect between the long-term nature of their investments (30 years and longer for certain pension funds) and the short-term behavior of their agents. For asset managers, integration of ESG factors into the investment process aims to better assess long-term risks or risks that have high impact but low frequency of occurence.

The aim of this paper is to provide a framework for integrating ESG considerations into the investment process of mainstream institutional asset managers. In particular, it introduces a portfolio analytical framework that aims to measure how well ESG factors are integrated across the entire portfolio and that can be used to set quantifiable objectives for improvement. The paper is organized in three sections. In section I, we seek to provide motivations and key rationales for integrating ESG into institutional portfolios. In section II, we examine how these objectives can be translated into the investment process through strategies for integration and engagement. We describe how investors can progress from a basic to an advanced level of implementation. In section III, we present our analytical approach for measuring and monitoring ESG risk at the portfolio level.

I. Main Motivations for Integrating ESG into the Investment Process

ESG Factors Viewed as Long-term Risks and Opportunities

A common motivation for integrating ESG into the investment process is to actively manage key factors that are believed to be important drivers of risk and returns. In this context, ESG factors can be used to select better-managed companies that can mitigate risks and exploit opportunities stemming from the key environmental and social issues. For example:

- Climate change will impact companies' bottom line in different ways across industries. Additional financial costs from carbon regulations in different jurisdictions globally may hit a diverse set of high intensity industries including utilities, airlines, and steel. Volatile

[1] Urwin, R (2011), Pension Funds as Universal Owners: Opportunity Beckons and Leadership Calls, Rotman International Journal of Pension Management, Volume 4, Issue 1 Spring 2011.

commodities prices stemming from changing weather patterns raise input costs in industries ranging from food to apparel. Companies with forward-looking strategies to mitigate the financial and operational risks specific to their industry are better positioned for competitive advantage, while laggards are vulnerable to unanticipated costs.

- Companies are increasingly reliant on a large, global workforce, exposing them to heightened risks of labor disruptions across their geographies of operation and throughout their supply chains. Accidents, suicides, protests, and strikes can negatively impact productivity, invite litigation, and damage company reputation. On the flip side, innovative human capital management helps attract and retain talent, raise productivity, and improve operational excellence.
- Access to scarce resources is a common key issue affecting the mining and oil & gas industries particularly for companies operating in geographies with weak regulatory and legal structures . Mining and oil & gas companies regularly encounter corrupt practices, social and political instability, and conflicts with local communities that threaten their license to operate. In the information technology and telecommunication sectors, competition for access to growth market frequently leads to companies trading off market share against regulatory and public concern over protection of privacy and civil liberties. Identifying companies with a strong governance strategy to mitigate these industry-specific risks protects against the downside surprises of operating in politically uncertain markets.
- ESG factors are as much about opportunities as risks. Redeployment of capital to emerging industries such as solar or wind will help create new industrial leaders. Beyond the obvious green markets, however, companies across many sectors enjoy upside opportunities associated with changing environmental and social trends. For example, tightening chemicals regulations that favor companies with cutting-edge green chemistry Research & Development; incentives in building, real estate, and transportation toward energy efficiency; and opportunities in food and nutrition driven by changing demographic trends and global economic growth.

Today's financial markets have difficulty incorporating low frequency but high impact risks in financial valuations. Because traditional financial analysis tends to focus on short-term earnings and operates within short-term benchmarks, it may be difficult to reconcile with key ESG issues that are aimed at uncovering risks in the medium to long term. The wealth destruction experienced by shareholders of BP after the Gulf of Mexico oil spill or of TEPCO after the nuclear accident at Fukushima are illustrations of this mis-pricing.

Universal Ownership and Externalities

Central to the philosophy of ESG investing is a concept called "Universal Ownership". A Universal Owner is defined as a long-term owner of a diversified investment portfolio that is spread across the entire market or markets. As a result, Universal Owners collectively own a share of the economy and are effectively tied into this share in the longer term. Universal Owners subscribe to the hypothesis that the long-term financial interest of their investments depends on the ability of global markets to produce economic growth on a sustainable basis. As a result, they infer that their actions should involve managing their longer term risk through asset allocations and active ownership practices that are sensitive to longer term ESG factors. In Exhibit 1, we summarize the distinctive features of the Universal Owner approach.

Exhibit 1: Characteristics of Universal Owners

- **Universal Owners are exposed to the entire market and economy – they own a slice of the world market and world economy now – and they will own this for the foreseeable future**
- **Universal Owners also own a large holding of corporate externalities which risk being internalized to the fund's net cost, now or in the future**
    - directly through individual stocks
    - indirectly through other holdings
    - obliquely in the form of social costs to others
- **Universal Owners can try to protect and grow the value of their holdings by seeking to manage their risk exposure to externalities through:**
    - Active ownership, collaboration in public policy efforts
    - Integration of ESG factors, investment in targeted ESG or sustainability mandates
- **Universal Owners can justify such actions with the belief that**
    - externalities are not valued correctly by today's market prices and
    - these actions are long-term insurances protecting against global risks

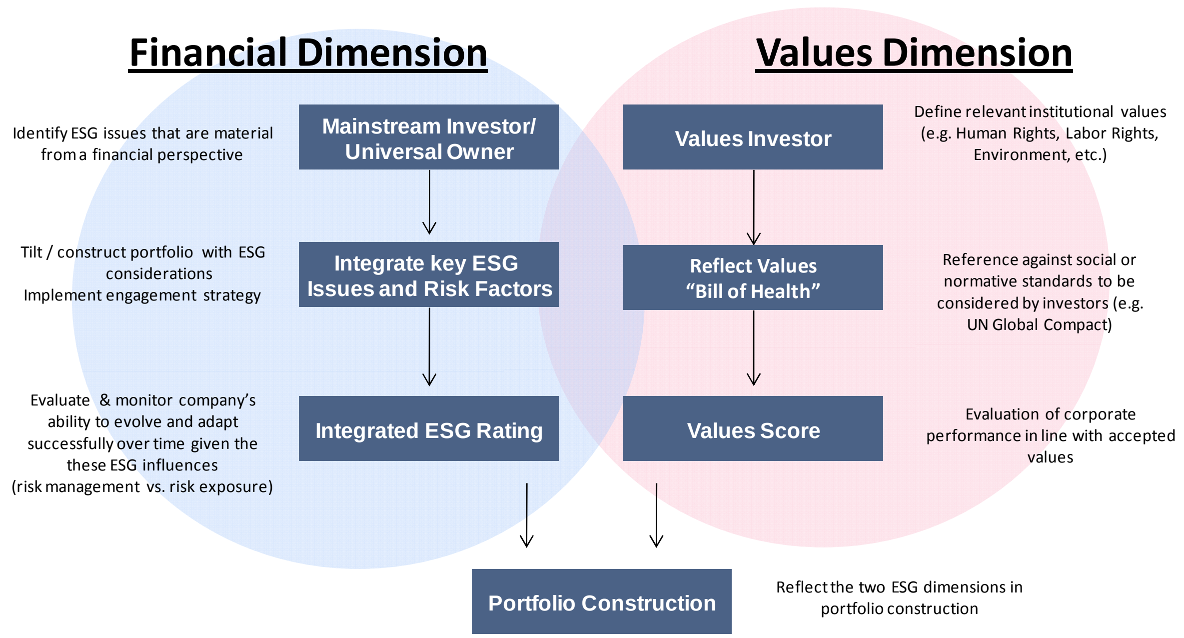
A key argument supporting ESG investing from the perspective of a Universal Owner is the realization of portfolio externalities. Portfolio externalities are spillover production or consumption effects that cause other unrelated parties to incur costs for which no appropriate compensation is paid. Such un-priced economic costs or benefits can often be internalized in investors' investment portfolios, often through cross-holdings. While investors are directly compensated by the current returns of their investment portfolios, they also indirectly own the externalities generated by companies, which may offset the portfolio return in future. Most long-term investors have the fiduciary responsibility to ensure multi-period sustainability of their investment portfolios.

Reflecting Values in the ESG Investment Process

In addition to the fiduciary dimension of ESG, many investors have a desire to reflect their values in their investment portfolios. Socially responsible investors have been advocating for many years an approach that combines investment returns with a social role for investing. These values could be based on religious views, international norms, institutional codes of conduct, legislative requirements, perception of controversial business activities and political pressure. This additional dimension is generally not driven by financial considerations but is there to ensure that the investment portfolios are congruent with investors' beliefs and values.

Another broadly accepted form of values investing refers to the management of reputational risk. For example, respect for human rights, adherence to international norms or conventions such as the UN Global Compact and the International Labor Organization Conventions, or avoidance of sin stocks are objectives very often pursued by institutional investors.

Exhibit 2: Two Dimensions of ESG Investing



In practice, motivations behind ESG investing generally encompass both financial and values considerations. The above diagram illustrates the two dimensions of ESG investing. The ability to recognize and distinguish between the two motivations is crucial because designing an ESG investment framework entails different investment approaches and implementation considerations.

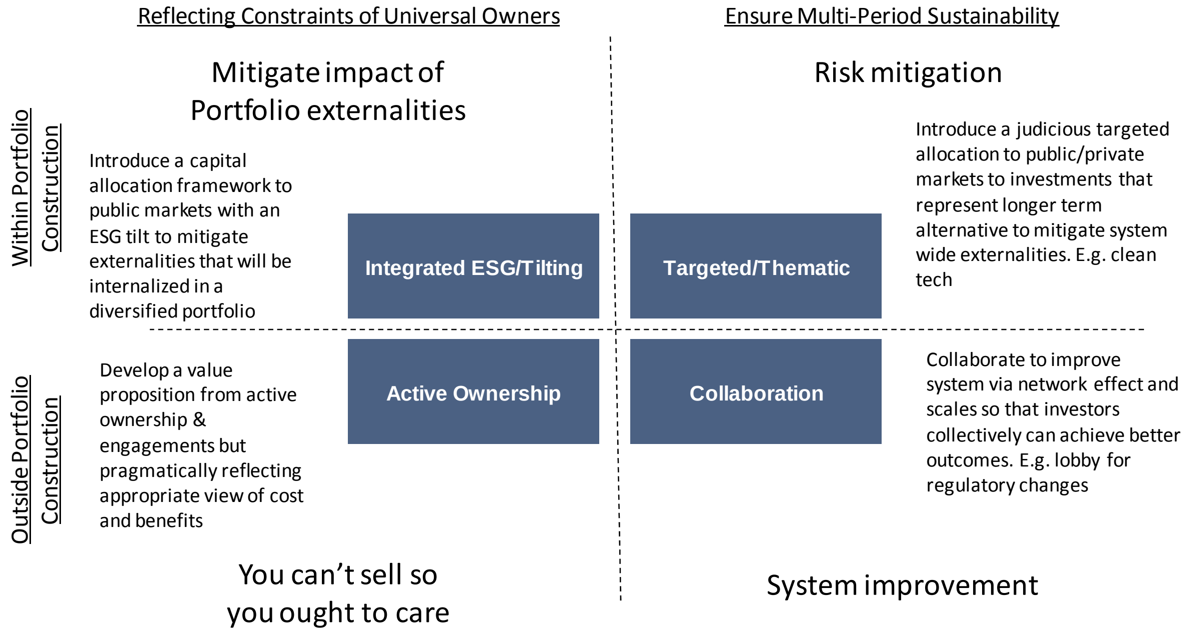
II. Strategies for ESG Integration

Possible Approaches to ESG Investing

There are different approaches that investors can take to implement ESG strategies. As depicted in Exhibit 3, they can be categorized into four categories depending on investment objectives and implementation strategies:

1) Integrated ESG or tilting
2) Active ownership
3) Targeted or thematic
4) Collaboration

Exhibit 3: Approaches to ESG Investing



Integrated ESG / Tilting Approach

The first approach involves tilting the portfolio to capture positive ESG factors while minimizing negative ESG exposures. Universal Owners who own a slice of the economy through their portfolios recognize that portfolio externalities have to be considered holistically. Selling or not owning certain companies on such considerations is not always an optimal strategy especially for finance-based investors. To address this constraint, investors could introduce a capital allocation framework that incorporates ESG factors into the investment decision-making process. The outcome typically involves overweighting highly ESG rated companies and underweighting lowly ESG rated companies when other financial considerations are equal. This is also commonly referred to as the integrated approach to ESG investing. In some instances, investors may also choose to apply negative screening to the portfolio by removing companies with business activities that are incompatible with their values from their investment universe. However, it is important to realize that this is an expression of the values dimension of ESG investing.

Active Ownership Approach

Sometimes, investors may prefer to take an active approach by engaging with companies that are less ESG conscious. Voting and engagement are tools for expressing active ownership. Investors pursuing this strategy believe that their actions could lead companies to behave in a way that is more in keeping with the long-term sustainability in the market place. In other words, active ownership is a tool for producing aggregate gains to market performance, albeit using bottom up methods. It can be seen as an approach that produces beta enhancement.

While active ownership is an approach that lies outside the conventional portfolio construction, investors often see it as an extension to the integrated approach of ESG investing. In some cases, investors use engagement as the last resort for keeping lowly ESG rated companies in a portfolio. Only when their engagement actions fail, will investors exclude companies in their portfolio.

Targeted/Thematic Approach

In addition, investors who are concerned with the potential threat of system-wide externalities may take a longer-term view by investing in companies that have business models that generate positive externalities. For example, investing in clean technology, renewable energy or water companies today can be viewed as a long-term risk mitigation strategy to address potential future energy shortage and climate change. A typical implementation strategy will involve carving out a dedicated allocation to these strategic investments. This approach is not dissimilar to buying a long-term portfolio insurance as a hedge to ensure multi-period sustainability of investment return.

Collaboration Approach

Finally, certain investors believe targeting system-wide improvement is the most effective means to achieve long term eco-system improvement and ensure multi-period sustainability of investment return. These investors may prefer a collaborative approach with all stakeholders including investors, companies, NGOs, interest groups, politicians and regulators. However, this approach can be significantly more laborious and resource intensive.

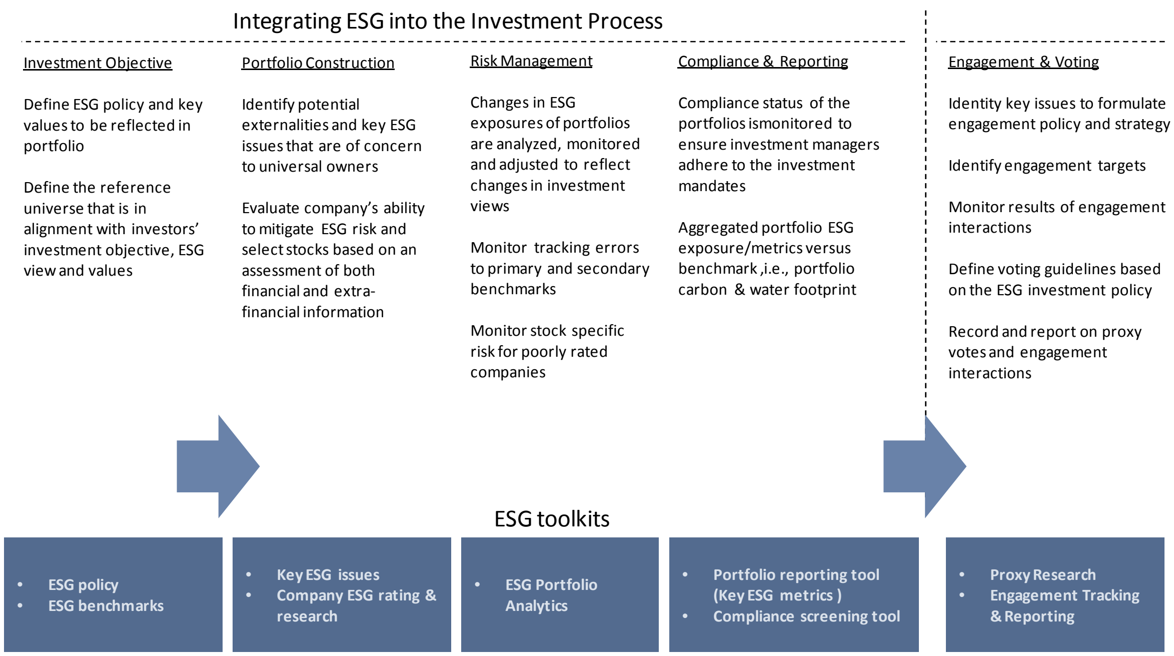
It is also important to note that the various approaches to ESG investing outlined above are not incompatible with each other. Investors could adopt one or several approaches in their investment process based on their expertise (competitive advantage) and resource constraints (governance budget).

ESG Investment Process and Essential ESG Toolkit

In this section, we present a general framework for an integrated ESG investment process with an active ownership extension and discuss the necessary toolkit required to manage such an investment process. The typical first step for an investment process is to define the investment mission and strategic objective. In addition to the risk and return parameters, choice of investment universe and market benchmark, a well-specified ESG policy is a critical component. The ESG policy should be congruent with investors' views on key ESG issues and potentially reflects specific institutional values if any. A comprehensive framework should cover policies and objectives for ESG integration, the desired strategies for implementation and the mechanism to monitor and take corrective actions. In the Appendix, we present a checklist for ESG integration that aims to calibrate the level of advancement in integration and suggests possible paths for improvement.

Exhibit 4 summarizes the key components of ESG integration and highlights some of the necessary tools to manage it.

Exhibit 4: An Integrated ESG Investment Process



Possible ESG Implementation Plan for Asset Owners

For an asset owner with a long-term horizon and mostly externally managed portfolios, the main focus of integration should be on defining ESG policies and reflecting those in the manager's mandates. Exhibit 5 outlines various stages of implementation that investors can pursue.

A basic implementation would see the asset owner 1) exercise their voting rights for most of the portfolio, typically by using a standard policy designed by a proxy research firm, 2) mandate ESG integration to the outside managers, typically by using the UN Principles of Responsible Investing (PRI) as a standard for ESG integration and 3) require regular reporting by managers but without necessarily pre-defining a standard set of reports. The main motivation is driven by the desire to limit potential reputational risk. However, this basic implementation has several limitations, mostly surrounding the lack of precision regarding objectives, constraints and measurement of the effectiveness of integration. However, it has the benefit of getting the process started without requiring a lot of investment or radical changes in policies and approaches.

Investors who believe that ESG is financially material would want to pursue a more effective implementation which would cover:

- The objectives for ESG, for example with reference to Universal Ownership and, if applicable, including a description of the institution's values that should be reflected in the portfolio. This will in turn help setting priorities for managers.

- The constraints applicable to the portfolio such as exclusion of the worst offenders or minimum standards for inclusion in the portfolio, as well as requirements for voting and engagement for the companies present in the portfolio

- Detailed reporting requirements. The request for information should cover details of the ESG processes followed by the managers, portfolio level statistics such as the ones described in the next section and a summary of the engagement agenda.

We believe that this intermediate level has the most potential to become an industry standard based on the current stage of industry development.

Finally, for investors who also regard the Universal Ownership principle as contextually appropriate and financially attractive can opt for more advanced approaches which entail formulating detailed ESG policies, active engagement with companies and regulators through publicly disclosed programs, active collaboration and sponsorship of research programs, systematic management of the worst-of-the-worst offenders with "Sell or Sue" policies.

Exhibit 5: Levels of Effective ESG Implementation

	Policy Position	Active Ownership	Integrated ESG/ Tilting	Targeted ESG/ Thematic	Collaboration
Finance-based	Limited beliefs in ESG materiality and/ or the need or capability to influence external managers on ESG.	Delegates active ownership activities to managers.	Considers ESG as part of managers' discretionary responsibility and expects such factors to be considered.	Would be considered as part of managers' thematic positions but in practice would rarely be present.	Does not view collaboration as helpful.
Basic	Wishes to limit reputational risks.	Monitoring confined to manager reports on activities. No explicit formats or goals in monitoring process.	Monitoring confined to considering manager reports on activities.		
	Believes that ESG is financially material and supports this belief through mandates to managers.	Delegates active ownership responsibility to managers or proxy service with more guidance on goals.	Specifies the integration of ESG as a formal part of manager mandates in keeping with UN PRI principles.	Would be considered as part of managers' thematic positions but in practice would rarely be present.	Joins UN PRI
Intermediate	Wishes to limit reputational risk	Specifies formats and goals for monitoring.	Requires reporting to demonstrate accordance with mandates and UN PRI. Considers the consolidated level ESG positions in accordance with UN PRI.		May consider the potential for collaboration in active ownership by using proxy service or governance overlay.
	Believes that ESG is financially material and supports direct and indirect management.	Undertakes active ownership directly and / or supported by proxy services or managers.	Integrates ESG into mandates.	Considers specific allocations to investments that specifically target the ESG and externalities themes.	More direct collaboration on engagement in exceptional cases.
Advanced	Considers the universal owner principles are contextually appropriate and financially attractive.	Develops exclusions or engagement list of companies.	May adopt rules-based portfolios tilted to ESG factors.		Join UN PRI and other industry associations to secure knowledge transfer and public policy lobbying.
		Develops monitoring and reporting for all activities.	Detailed reporting of ESG positions at manager and consolidated level in accordance with UN PRI		
Values-based	Wishes to invest in a way that is congruent with certain mission specific values or to support certain mission specific goals.	Develops exclusions or engagement list of companies. Undertakes active ownership using managers/proxy services. Develops monitoring and reporting for all activities.	Specifies ESG preferences in mandates. Detailed reporting of ESG positions at manager and consolidated level, including those identified by controversies and business activity groupings.	Considers specialized allocations to investments in mission specific areas.	Considers collaborations that produce network effects aligned to the missionspecific goals.

Possible ESG Implementation Plan for Asset Managers

For asset managers, the key focus for ESG integration is at the portfolio construction level. While a basic level of implementation has the benefit of bootstrapping the process of integration it may not be very effective in raising the ESG profile of the portfolio.

A more advanced implementation for asset managers that has the potential to become an ESG industry standard would include:

Policy statements:

- A policy statement that reflects the managers' understanding of the motivation of the asset owner typically along the dimensions of Universal Ownership, ESG risk or values-driven criteria. This statement would also define ex-ante what is expected from the ESG investment strategy: increase ESG profile of portfolio, reduce risk, engage companies for real changes etc.

Risk management strategy:

- A risk management strategy that requires a systematic portfolio-level review of lowly rated companies. It should incorporate an alert system to portfolio managers as well as an explicit review of the most problematic investments through written justification to invest or a formal discussion at the investment committee. The overall level of portfolio risk should be also monitored, possibly by establishing a benchmark requirement on the number of lowly rated companies in the portfolio or an aggregate portfolio ESG score that is not lower than the market benchmark. In addition, having such an integrated risk management framework could also facilitate systematic identification of potential mis-priced opportunities.

Engagement and voting policy:

- A well-defined engagement and voting policy that articulates the manager's views on key ESG issues. Setting a realistic scope and level of ambition for engagement is critical to attaining objectives within the constraints of time, cost, and resources. In formulating a company's voting and engagement policy, investors should identify a list of key ESG issues most relevant to them and use it to identify and prioritize engagement targets. It is also important that investors continuously monitor results of their engagement interactions and take appropriate actions should their engagement actions fail, which could then move to shareholder resolutions.

Execution process across portfolios:

- A process to ensure consistency of execution across all portfolios. This can be achieved by instituting regular reviews of portfolios and engagement records.

The definition of best practices in ESG integration is evolving very quickly. A few years ago, being an UN PRI signatory was considered advanced; it is now seen as a requirement for large institutional asset managers. Effective monitoring and measurement of ESG integration is quickly becoming a differentiating factor.

III. ESG Risk Management at Portfolio Level

Effective Portfolio Analytic Framework

To ensure effective risk management, it is important that institutional investors understand the sources of ESG risk and have an overall appreciation of ESG risk at the portfolio level. A simple, yet effective, approach to ESG risk measurement can be built using the notion of risk exposure. For this, investors may require a portfolio analytic framework as outlined in Exhibit 6 that would provide an overall attribution of the portfolio's ESG exposures and risk management performance on key ESG issues. The ESG analytic framework should facilitate understanding of ESG risk at security, sector, key issues and portfolio level. For example, each investment in the portfolio could be given a risk rating (from AAA to CCC) or risk score. This risk exposure input could then be aggregated as a weighted average at the portfolio level. Changes in ESG exposures at the portfolio level should be regularly analyzed, monitored and adjusted to reflect changes in investment views in a similar fashion to other investment risks. In addition, companies with deteriorating ESG performance or those involved in various high profile areas ('controversies') should be actively monitored to ensure the portfolio ESG risk is well understood. The portfolio monitoring would typically be done on a cycle consistent with how quickly these issues can change, often suggesting a monthly or quarterly basis.

In measuring and attributing ESG risk, it is important to have relevant benchmarks as a reference. We suggest measuring the portfolio against two benchmarks: a broad market cap weighted index such as the MSCI World Index or the MSCI ACWI IMI which will reflect the state of the markets without ESG integration and an ESG benchmark such as the MSCI World ESG Index which selects companies with best- of-class ESG management. For investors who are reflecting certain values in their investment process a values-based ESG benchmark such as the MSCI World Socially Responsible Index could also be considered.

Typically, a fund well-integrated with respect to ESG factors should be expected to have risk exposure levels similar to those of the best-of-class ESG benchmark. As a rule of thumb, a portfolio from a UN PRI signatory could be expected to have risk scores falling between the market average and the best-of-class benchmark. Scores lower than the market would require detailed explanations. While owning lowly rated issuers is not necessarily incompatible with ESG integration, such ownership should be linked to a combination of very attractive valuations and a very active engagement strategy.

Exhibit 6 describes a possible standard portfolio ESG risk assessment report that compares the portfolio to the reference benchmarks with decomposition by rating bands, sectors, and key ESG issues.

In this example, the portfolio has an above average ESG score (+0.15) compared to its market benchmark (MSCI World Index) but is still lagging behind the best-of-class ESG portfolio (MSCI World ESG Index) which has a superior score (+0.32) relative to the same market benchmark. In comparison to the market benchmark, the portfolio has a better ESG profile for almost all sectors except Consumer Discretionary and Consumer Staples. However, the portfolio only fares better in Energy, Telecommunication Services and Utilities when comparing to a best-of-class ESG portfolio.

Exhibit 6: An Illustration of a Portfolio Analytic Framework

	Portfolio	MSCI World ESG		Portfolio	MSCI World ESG
Index/Portfolio Level	**Relative ESG Scores**			**Relative ESG Scores**	
Portfolio Scores	+0.15	+0.32	**Environment**	**+0.14**	**+0.22**
			Risk Factors	+0.09	+0.32
[+] Key ESG Pillar			Environmental Management Capacity	+0.06	+0.25
Environment	+0.14	+0.22	Opportunity	+0.27	+0.08
Social	+0.16	+0.31			
Governance	+0.22	+0.04	**Human Capital**	**+0.17**	**+0.31**
			Health & Safety	+0.07	+0.32
			Labor Relations	+0.50	+0.42
[+] ESG Scores by Sector			Employee Motivation & Development	-0.06	+0.20
Energy	+2.53	+1.06			
Materials	+0.08	+0.34	**Stakeholder Capital**	**+0.15**	**+0.32**
Industrials	+0.10	+0.21	Product Safety	+0.29	+0.31
Consumer Discretionary	-0.03	+0.83	Supply Chain	-0.29	+0.28
Consumer Staples	-0.23	+0.92	Customer/ Stakeholder Partnerships	+0.12	+0.45
Health Care	+0.17	+1.08	Local Communities	+0.24	+0.73
Financials	+0.36	+0.69			
Information Technology	+0.79	+1.38	**Strategic Governance**	**+0.22**	**+0.04**
Telecommunication Services	+0.60	+0.15	Traditional Governance Concerns	+0.32	+0.08
Utilities	+1.80	+0.85	Strategic Capability / Adaptability	+0.12	+0.01

Notes:
1. A positive relative ESG score indicates an above average ESG performance versus the market benchmark (MSCI World) and vice versa.
2. The MSCI World ESG Index includes companies with the best-of-class ESG performance.

Another useful dimension is to examine the exposure of a portfolio to various key ESG issues across industries. The above example highlights that the portfolio scores lowly on Employee Motivation and Development as well as Supply Chain compared to the market benchmark. This suggests that these are the areas that require additional monitoring or potential engagement by the investor. Such analysis can provide valuable insight on the ESG characteristics of a portfolio.

Assessing Company Level ESG Risk

At the security level, ESG ratings and scores can also be used to highlight holdings that are contributing most to the ESG risk of the portfolio. For example, Exhibit 7 provides information on companies in a portfolio with the lowest ESG scores as well as companies that are involved in ESG related controversies and controversial activities. Such information could be used to facilitate special monitoring as well as formulating active engagement strategies to address specific ESG issues. In addition to ESG risk factors, managers could also report portfolio holdings that have high actual or potential controversy exposures such as social and/or human rights impact. It could also serve as a communication tool to highlight potential reputational risks from companies in the portfolio that have been implicated in major controversies.

Exhibit 7: Company Level ESG Risk Assessment

Bottom Rated Companies by Portfolio Weight				
Rank	**Name**	**Weight**	**Industry**	**Rating**
1	Company A	0.97%	Financials	CCC
2	Company B	0.65%	Consumer Discretionary	CCC
3	Company C	1.94%	Health Care	B
4	Company D	1.41%	Consumer Discretionary	B
5	Company E	1.05%	Information Technology	B
6	Company F	1.03%	Utilities	B
7	Company G	1.01%	Financials	B
8	Company H	0.89%	Industrials	B
9	Company I	0.84%	Materials	B
10	Company J	0.84%	Financials	B

Companies Involved in Controversies by Portfolio Weight						
Rank	**Name**	**Weight**	**Environment**	**Human Rights**	**Labor Rights**	**Governance**
1	Company A	1.64%			Y	R
2	Company B	1.35%	Y	R	Y	Y
3	Company C	0.84%			Y	R
4	Company D	0.84%	Y	Y	R	Y
5	Company E	0.84%	R	R	Y	
6	Company F	2.44%		Y	Y	
7	Company G	2.42%	Y			Y
8	Company H	1.89%				Y
9	Company I	1.37%		Y		Y
10	Company J	1.31%			Y	

Companies Involved in Business Activities by Portfolio Weight			
Rank	**Name**	**Weight**	**Business Activity Type**
1	Company A	2.42%	Iran
2	Company B	2.13%	Stem Cell; GMO
3	Company C	1.89%	Iran
4	Company D	1.12%	Alcohol; GMO
5	Company E	1.01%	Iran
6	Company F	0.95%	Iran
7	Company G	0.84%	Sudan
8	Company H	0.84%	GMO
9	Company I	0.84%	Nuclear Power
10	Company J	0.78%	Iran

Conclusion

The growing acceptance of the UN Principles for Responsible Investment indicates that ESG investing is becoming a mainstream investment approach. However, the absence of clarity and standards relating how to integrate ESG into the investment process has been a key challenge to wider adoption and acceptance.

This paper demonstrates how an integrated investment process can be constructed which starts from a clear definition of investment goals to reflect the investor's investment beliefs. When accounting for ESG, institutional investors split into two groups: those that want to reflect such factors for reasons of longer term performance; and those that want to do so because they wish to invest in ways congruent with their values. The ESG process must separate the financial and values dimensions, while recognising that some investors will choose a combination of both.

The benefits for investors of taking a system-wide and multi-period approach to ESG are highlighted in the concept of Universal Ownership and portfolio externalities. Such an approach brings to the fore both the portfolio allocation considerations in portfolio construction and the active ownership and collaboration opportunities outside portfolio construction.

It is obviously difficult to estimate particular externalities and pathways to internalizing them, and other critical aspects of ESG. But that makes successful integration of ESG into an investment process a key differentiator. Institutional investors will need to be skillful in their assessment of these hard-to-estimate values. They also need expanded support for their decisions through new benchmarks and security-level models that assess ESG factors in detail.

We argue that the more systematic use of portfolio-level ESG risk measurement tools will help move ESG integration from a state that is too often aspirational to one that will have effective impact on portfolios. As Peter Drucker highlighted: "what gets measured, gets managed".

Appendix

Checklist for ESG Integration

Approach	*ESG check-list*	*Finance Based*			*Values- based*
		Basic	*Intermediate*	*Advanced*	
Active Ownership	Active ownership delegated to managers	Y			
	Active ownership delegated to proxy service with fund guidelines to voting and active positions		Y		
	Active ownership through delegation to overlay manager		Y		
	Active ownership including preparedness to engage with investee companies			Y	
	Monitoring of managers at high level on active ownership delegations		Y		
	Monitoring of managers at detailed level on active ownership activities			Y	
	Monitoring of holdings for exclusion - for reputational or values-based reasons				Y
	Reporting of active ownership policies and activities		Y	Y	
Integrated ESG	Integrated ESG expected of equity managers	Y			
	Integrated ESG specified in equity mandates		Y	Y	
	Integrated energy-efficient approach to real estate			Y	
	Integrated approach to sovereign and corporate bonds			Y	
	Monitoring at high level of manager mandates checking conformity with mandates		Y	Y	
	Monitoring at portfolio level through individual investment-level assessment and consolidation		Y	Y	
	Reporting on integrated ESG	Y	Y	Y	
Targeted ESG	Investment in ESG-tilted portfolios through rules-based approaches			Y	
	Investment in ESG-targeted portfolios in quoted equity			Y	
	Investment in ESG-targeted portfolios in private equity			Y	
	Investment in mandates with specified exclusions			Y	
	Investment in mission-specific portfolios				Y
	Monitoring of ESG exposures versus market averages				
	Monitoring of more specific extra-financial outcomes versus goals			Y	Y
	Reporting on targeted ESG activities			Y	Y
Collaboration	UN PRI signatory process		Y	Y	
	UN PRI validation at highest level		Y	Y	
	UN PRI validation at detailed level			Y	
	UN PRI Clearinghouse work with other funds on active ownership and equivalents			Y	
	Other collaborations – CGN, SIFs, ...			Y	
	Universal ownership activities lobbying for public policy changes.			Y	

Contact Us

esgclientservice@msci.com

Americas	Europe, Middle East & Africa	Asia Pacific
+1.212.804.5299	+44.207.618.2510	+612.9033.9339

Notice and Disclaimer

About MSCI ESG Research

MSCI ESG Research is a leading source of environmental, social and governance (ESG) ratings, screening and compliance tools to advisers, managers and asset owners worldwide. Its products and services are used by investors to integrate ESG factors into their investment processes.

MSCI ESG Research is the successor of sustainability pioneers KLD, Innovest and IRRC, which were acquired through MSCI's acquisition of RiskMetrics. ESG ratings, data and analysis from MSCI ESG Research are also used in the construction of the MSCI ESG Indices.

About MSCI

MSCI Inc. is a leading provider of investment decision support tools to investors globally, including asset managers, banks, hedge funds and pension funds. MSCI products and services include indices, portfolio risk and performance analytics, and governance tools.

The company's flagship product offerings are: the MSCI indices which include over 148,000 daily indices covering more than 70 countries; Barra portfolio risk and performance analytics covering global equity and fixed income markets; RiskMetrics market and credit risk analytics; ISS governance research and outsourced proxy voting and reporting services; FEA valuation models and risk management software for the energy and commodities markets; and CFRA forensic accounting risk research, legal/regulatory risk assessment, and due-diligence. MSCI is headquartered in New York, with research and commercial offices around the world.