Integrating ESG

Sustainable investing techniques and implications for performance professionals

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Leveraging transformational investment practices

Expectations for asset managers are evolving rapidly among investors (institutional & retail) and society at large

- As the connection between sustainability and valuation of financial assets becomes clearer, regulatory and client demands are forcing asset managers to fully integrate ESG factors into their investment processes
- Asset managers collectively control more than $110 trillion in assets globally and are increasingly expected to provide positive societal impact

Initiating an internal discussion about purpose is challenging

- Senior managers and employees can respond resisting change given their deep-rooted understanding of their mandate
- A profound examination of fiduciary duty indicates that, far from being a barrier, considering ESG risk factors is an obligation towards investors
- As stewards of capital, asset managers strive to achieve the highest risk-adjusted return for the allocated capital. The underlying risk assessment should include material ESG factors

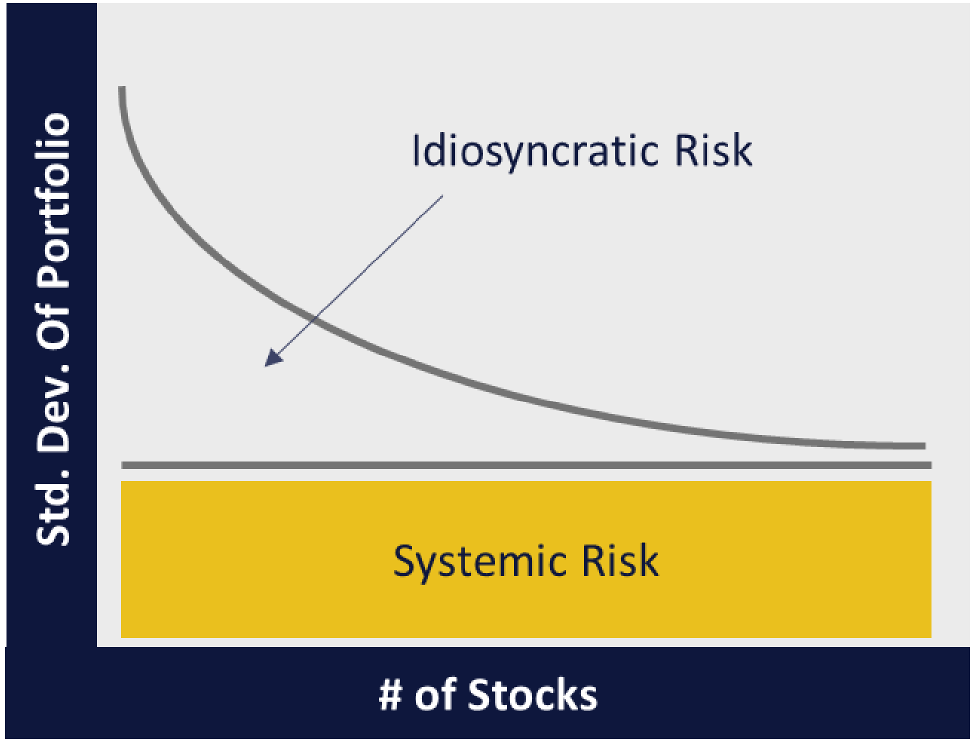
Defining ESG integration

ESG Integration

The explicit and systematic inclusion of ESG factors in investment analysis, decision-making, and operational processes

- ESG integration is a holistic approach to investment processes, where material factors—ESG factors and traditional financial factors—are identified and assessed to form an investment decision.
- ESG integration is NOT
  - Establishing investment prohibitions in certain sectors, countries, and companies
  - Sacrificing portfolio returns to perform ESG integration techniques
  - Allowing immaterial ESG factors to affect investment decisions and ignoring traditional financial factors
  - A mandate to implement major changes to your investment process
- Immaterial ESG issues should not affect investment decisions nor hinder operations
  - Only if traditional financial and ESG factors are analyzed and found to be material, an assessment of their impact should be carried out and incorporated into the investment process

Climate risk, inequality are non-diversifiable systemic risks



Institutional and retail investors are realizing that volatility and value-destruction driven by climate, pandemics, inequality and injustice threaten the vast majority of value in their diversified portfolios.

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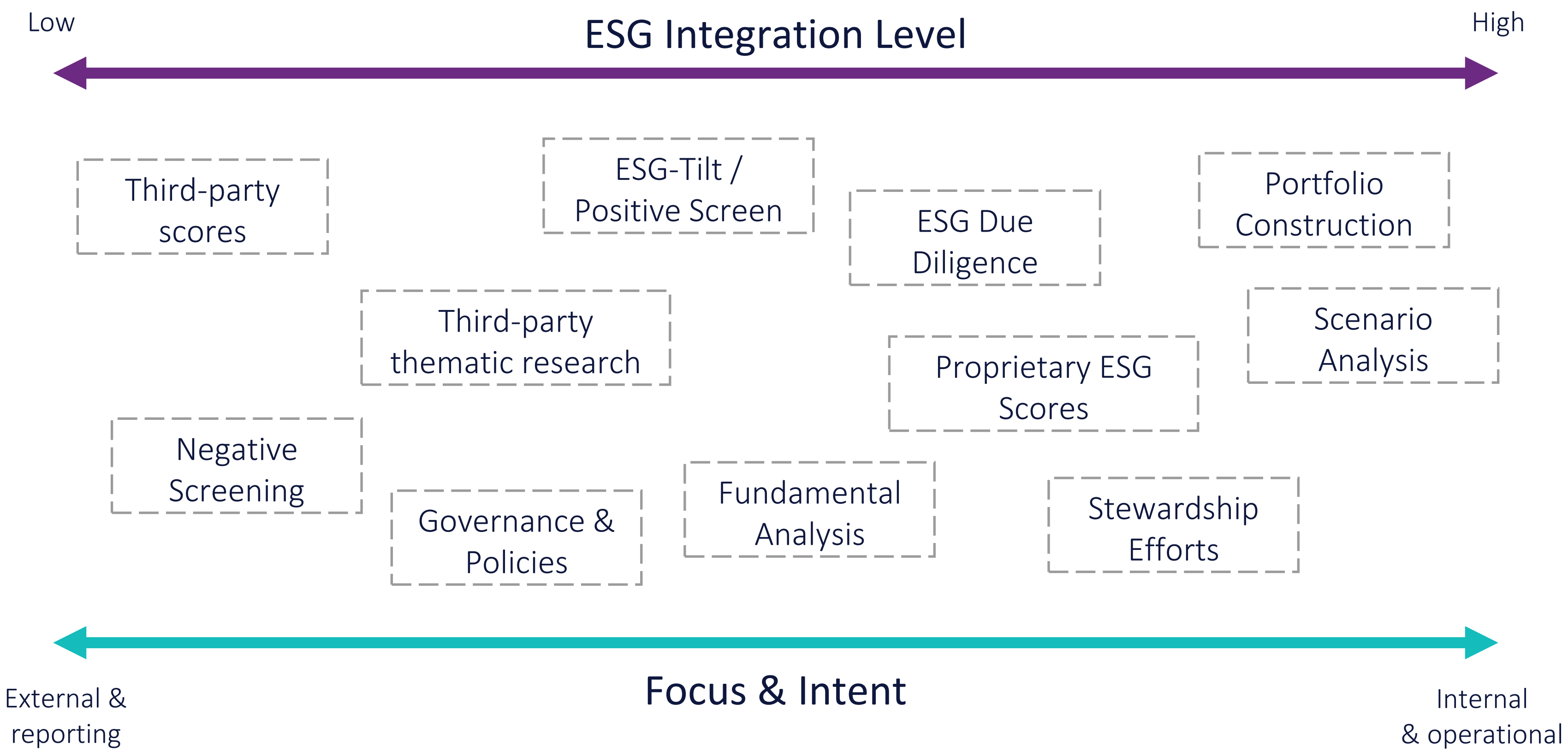
ESG integration spectrum

Integration Methodologies

1. Exclusion or norms-based screening
2. Negative screening
3. Positive or best-in-class screening
4. Fundamental integration
5. Factor investing
6. ESG tilts
7. Thematic investing
8. Impact investing
9. Responsible investment in passive or ruled-based investing
10. Three-dimensional investing
11. Active ownership (voting, engagement, litigation)
12. Public policy engagement



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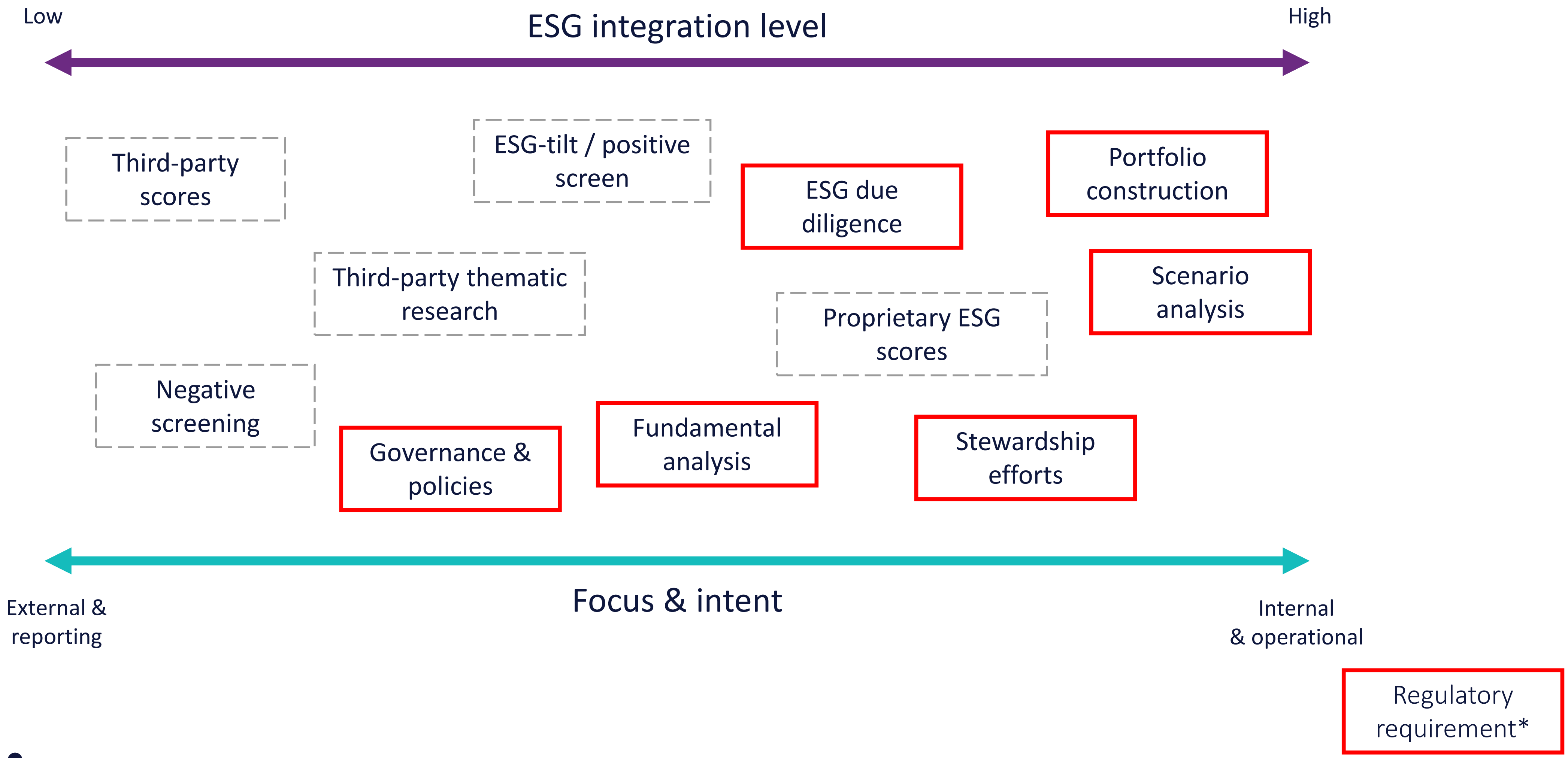
Regulatory guidelines requirements are comprehensive



*Where deemed **FINANCIALLY MATERIAL**

Environmental integration framework

Environmental Risk Management

Materiality assessment

Governance and strategy

Research & portfolio construction	Risk management
Stewardship	Disclosure

Integration applies to the extent that it is material to assets managed

Significant environmental changes in the short and long term, can have a considerable impact on the value of financial assets and portfolios, making environmental risks financially material.

How can performance and attribution professionals help?

Third-party scores

Understanding underlying methodologies

- What is measured
- How it is measured
- Factor weight in score
- Source

Third-party scores

Understanding underlying methodologies

- **What is measured**
- How it is measured
- Factor weight in score
- Source

	Vendor 1	Vendor 2	Vendor 3
E Factors	Waste Management Water Management Emissions Resource Use Environmental Management Environmental Stewardship Environmental Solutions	Carbon efficiency Waste efficiency Water efficiency Avoiding Environmental Harm	GHG Emissions Air Quality Energy Management Water & Wastewater Management Waste & Hazardous Materials Management Ecological Impacts
S Factors	Compensation Diversity Employment Quality Human Rights Labour Rights Occupational Health and Safety Product Quality and Safety Training and Development Community Relations	Employment Tax gap Product Design & Lifecycle Management Avoiding social harm Economic development Avoiding water scarcity	Human Rights & Community Relations Customer Privacy Data Security Access & Affordability Product Quality & Safety Customer Welfare Selling Practices & Product Labeling Labor Practices
G Factors	Business Ethics Corporate Governance Transparency Capital Structure Forensic Accounting	Board diversity Executive pay Board independence	Business Ethics Competitive Behavior Supply Chain Management Critical Incident Risk Management Systemic Risk Management Management of the Legal & Regulatory Environment

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Third-party scores

Understanding underlying methodologies

What is measured

How it is measured

Factor weight in score

Source

Datapoint Name	Definition	Data Type
Affordable Housing Overall-Revenue Percentage	The overall % share of total revenue coming from Affordable Housing	Numerical
Affordable Housing Overall-Level of Involvement Range	Overall level of involvement range for the indicator	String
Energy Efficiency Overall-Revenue Percentage	The overall % share of total revenue coming from Energy Efficiency	Numerical
Energy Efficiency Overall-Level of Involvement Range	Overall level of involvement range for the indicator	String
Financial Inclusion Overall-Revenue Percentage	The overall % share of total revenue coming from Financial Inclusion	Numerical
Financial Inclusion Overall-Level of Involvement Range	Overall level of involvement range for the indicator	String
Green Buildings Overall-Revenue Percentage	The overall % share of total revenue coming from Green Buildings	Numerical
Green Buildings Overall-Level of Involvement Range	Overall level of involvement range for the indicator	String
Green Transportation Overall-Revenue Percentage	The overall % share of total revenue coming from Green Transportation	Numerical
Adult Entertainment Production Product Involvement		Binary (yes or no)
Adult Entertainment Distribution Product Involvement		Binary (yes or no)
Alcoholic Beverages Production Product Involvement		Binary (yes or no)
Alcoholic Beverages Related Products/Services-Product Involvement		Binary (yes or no)
Alcoholic Beverages Retail Product Involvement		Binary (yes or no)
Scope 1	Gross global Scope 1 emissions	Numerical
Environmental Management	Discussion of long-term and short-term strategy or plan to manage Scope 1 emissions, emissions reduction targets, and an analysis of performance against those targets	String
Air Travel Fuel Efficiency	(1) Total fuel consumed, (2) percentage alternative, (3) percentage sustainable	Numerical
Selling Practices & Product Labeling	(1) Number and (2) percentage of covered employees with a record of investment-related investigations, consumer-initiated complaints, private civil litigations, or other regulatory proceedings	Numerical
Selling Practices & Product Labeling	Total amount of monetary losses as a result of legal proceedings associated with marketing and communication of financial product-related information to new and returning customers	Numerical
Transparent Information & Fair Advice for Customers	Description of approach to informing customers about products and services	String

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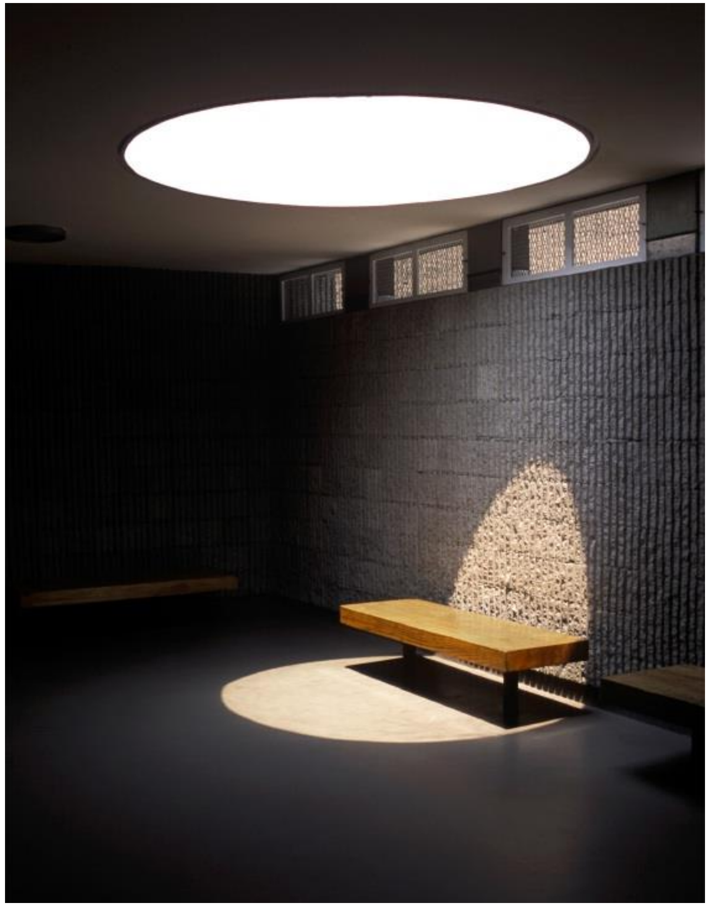
How can performance and attribution professionals help?

ESG Performance & Attribution Analysis

Which E, S, and G factors are financially material (sector/company level)?



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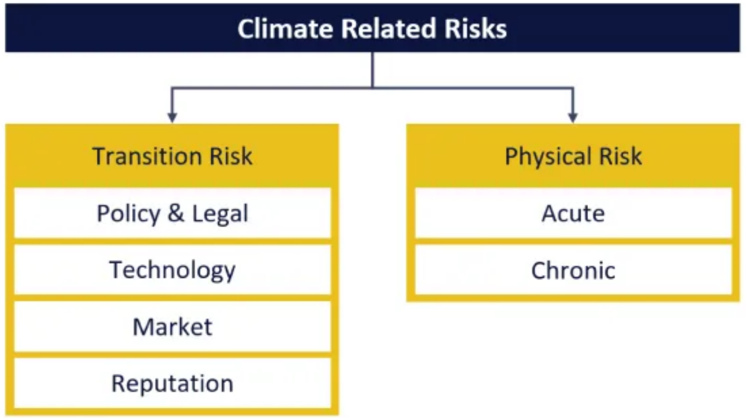
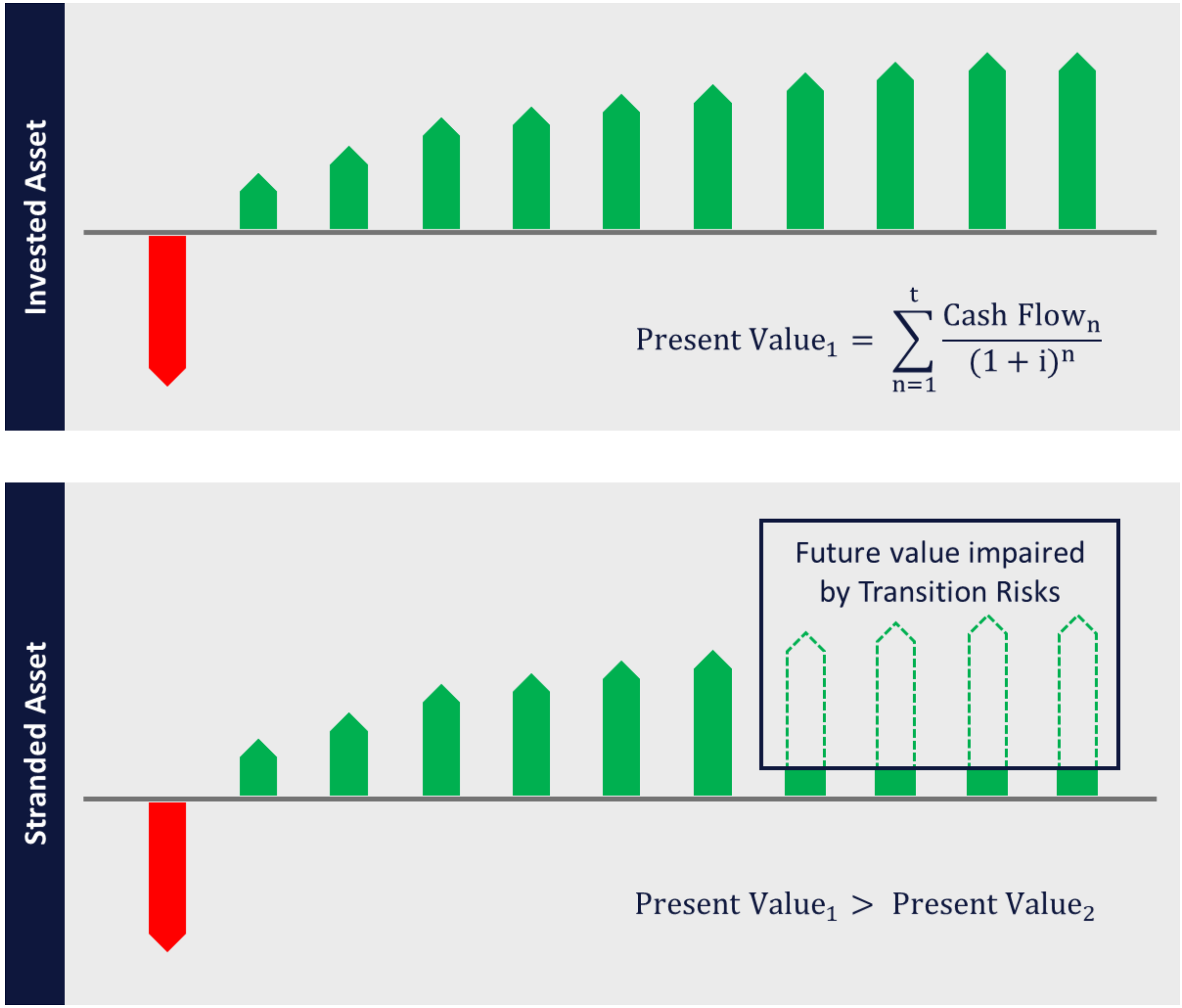
Time horizon of materiality





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ESG Integration Techniques

ESG Integration

1. Governance and Policies

A. Responsible investment policy
B. Peer review and best practices
C. ESG program execution roadmap
D. ESG governance and committee design

2. Strategy

A. Integration techniques
B. Research
C. Portfolio Management
D. Risk Management
E. Product, Sales & Distribution
F. External mandate management
G. Stewardship and engagement (separate offering)

3. Operations

A. Vendor Evaluation and Selection
B. Reporting and Disclosure
C. Data management
D. Technology infrastructure
E. Outsourced ESG team

ESG integration tailored to asset owners' operating model

Strategic Vision
- Universal ownership
- Systemic trends
- Long-term stakeholder map
- Contributors and beneficiaries

Governance and Approach
- Board of directors
- Senior management
- Responsible investment policy

Investment Team

Internal Management

Research
- Materiality assessment
- Sector specific guidance
- Asset class nuances
- Security valuation

Portfolio Management
- Asset allocation
- Portfolio level guidance
- Portfolio construction
- Security level guidance

External Mandates

Asset Manager Engagement
- Mandate requirements and RFPs
- Manager appointment
- Manager selection
- Manager monitoring

Non-Investment Areas

Risk Management
- Ongoing monitoring
- Capacity building
- Scenario analysis
- Compliance & internal audit
- Risk measurement & budgeting
- Escalation guidelines

Stewardship
- Proxy voting guidelines
- Collaborative platforms
- Investee engagement

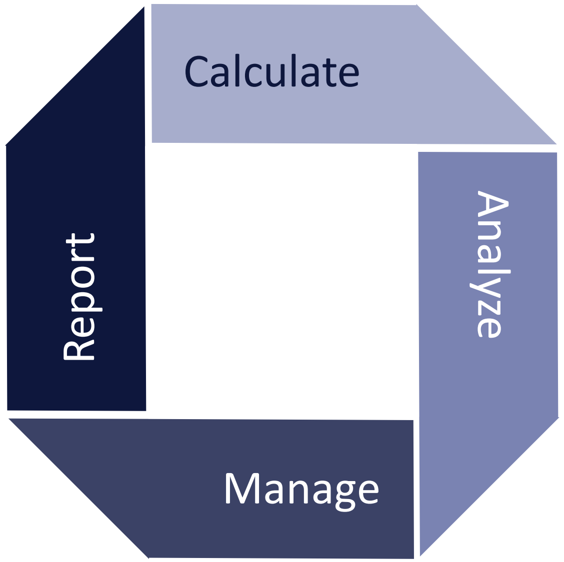
Disclosure
- Investors
- Regulators
- Intl. standards

Operational Model
- Data management
- Vendor selection
- Organisational structure
- Technology infrastructure

Climate risk management

1. Net-Zero Transition Plans & Carbon Footprints

- Determine the overall portfolio carbon footprint and intensity



Calculate:
- Determine the overall portfolio carbon footprint and intensity

Analyze:
- Create a Portfolio Decarbonization Roadmap
- Prioritize portfolio companies for decarbonization
- Identify priority decarbonization actions

Manage:
- Determine the highest emitting activities across portfolio companies and value-chains
- Benchmark the decarbonization performance and ambitions of peers
- Act on risks & opportunities Identify priority decarbonization actions

Report:
- Automate disclosure requirements for all stakeholders
- Track progress against an updateable baseline

ESG Integration - Strategy

Portfolio Management

1. Integration Guidance:

- Security level*- Answer questions such as how to price carbon emissions, valuation premiums for ESG compliant firms vs. non-compliant
  - **Forecasted financials:** Adjustments are made to forecasted financials (e.g., revenue, operating cost, asset book value, capital expenditure) for the expected impact of ESG factors
  - **Valuation-model variables:** Adjustments are made to valuation-model variables (e.g., discount rates, perpetuity growth, terminal value) for the expected impact of ESG factors
  - **Valuation multiples:** Adjustments are made to valuation multiples to calculate "ESG-integrated" valuation multiples.
  - **Forecasted financial ratios:** Forecasted financials and future cash flow estimates are adjusted for ESG analysis and the effect on financial ratios is assessed
- Portfolio level
  - **ESG profile (versus benchmark):** The ESG profile of portfolios is examined for securities with high ESG risks and assessed relative to the ESG profile of a benchmark
  - **Tactical asset allocation:** TAA strategies factor in ESG objectives and analysis to mitigate short-term ESG risks
  - **Strategic asset allocation:** SAA strategies factor in ESG objectives and analysis to progressively mitigate the ESG risks and enhance financial performance

CFA Institute - UN PRI ESG Integration Framework

*The most popular metrics to adjust are profit margins, sales growth, and cost of capital. Capex and working capital are adjusted to a lesser extent.

ESG Integration - Governance and Policies

Responsible Investment Policy

- Responsible Investment Policy (Integrated Investment Policy vs. Standalone Responsible Investment Policy)
  - **Purpose:** Why the policy has been developed and how the organization defines responsible investment
  - **Scope:** Whether the policy applies to all assets under management, or certain geographic regions or asset classes
  - **Legal and regulatory factors:** The legal and regulatory requirements or fiduciary responsibilities guiding the organization
  - **Responsibilities:** The individual(s) accountable for achieving the policy's commitments
  - **Implementation:** How the organization plans to fulfil the commitments and monitor progress
  - **Engagement:** How the organization will encourage investees to improve ESG risk management and develop more sustainable business practices
  - **Reporting:** How the organization intends to report on progress
  - **Review:** How and when the policy will be reviewed


INVESTMENT POLICY

Purpose of this policy

Definitions


sible Investment Policy

1. Purpose

2. Scope

ESG Integration - Governance and Policies

ESG Governance and Committee Design

- Include the new responsibilities to the Board of Directors and Senior Management

  Example- The Board, or a committee delegated by it, is responsible for:
  - Approving an environmental risk management framework and policies to assess and manage the environmental risk of the assets managed, taking into consideration the asset manager's fiduciary role and other legal obligations vis-à-vis its customers;
  - Setting clear roles and responsibilities of the Board and senior management, including personnel and functions responsible for oversight of environmental risk of the assets managed; and
  - Ensuring that directors have adequate understanding of environmental risk, and senior management is equipped with appropriate expertise for managing environmental risk.
- Clear allocation of responsibilities for management of environmental risk in accordance with the three lines of defense model (Risk, compliance, internal audit)

  Example- Senior management is responsible for:
  - Ensuring the development and implementation of an environmental risk management framework and policies, as well as tools and metrics to monitor exposures to environmental risk, including resilience of the funds/mandates managed by the company to different environmental scenarios. The framework should include how the asset manager incorporates environmental risk considerations in its investment research, portfolio construction, risk management and stewardship practices across different asset classes and investment strategies;
  - Reviewing regularly the effectiveness of the framework, policies, tools and metrics and making appropriate revisions, taking into account changes in the asset manager's business, size and complexity as well as risk environment;
  - Establishing an internal escalation process for managing environmental risk (including material environmental risk exposures and exceptions to the environmental risk management framework or policies), and that appropriate and
  - timely actions are taken to address the risk; and
  - Allocating adequate resources with appropriate expertise, including through capacity building and training, to manage the environmental risk of the assets managed

ESG Integration - Strategy

Research

1. Advanced ESG Data Analysis

Develop a framework to integrate ESG **analysis** into investment processes and **measure** and **monitor** potential implications of systemic ESG opportunities and risks.

	Requires	
Analysis		Developing a standardized and repeatable workflow
Measure		Implementing a robust quantification process
Monitor		Generating visualization methods and periodic reports to share internally and externally

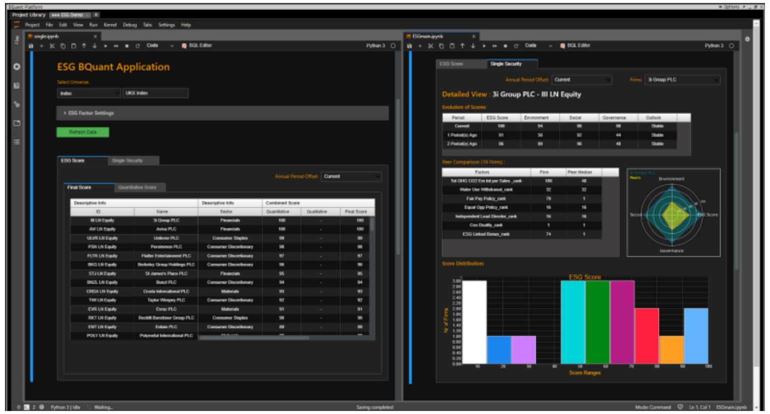
\+ Robust Data

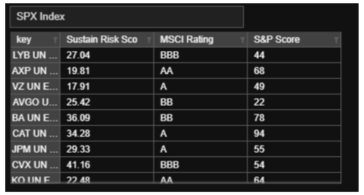
ESG Integration - Strategy

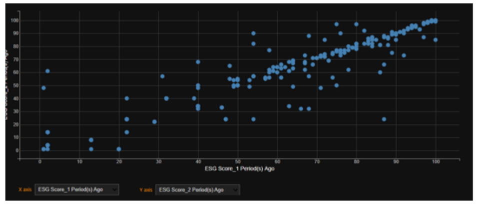
Research

2. Ratings Analysis And Construction

Build the necessary tools to build proprietary ESG scores (based on industry standards such as SASB or on proprietary materiality maps) and to compare ESG ratings from various data providers on a peer-to-peer basis.





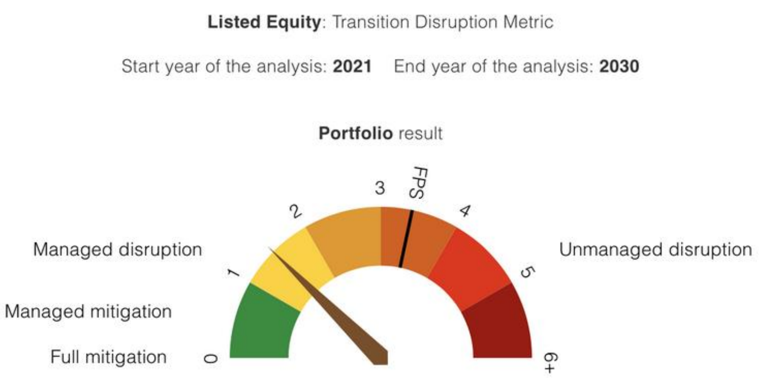


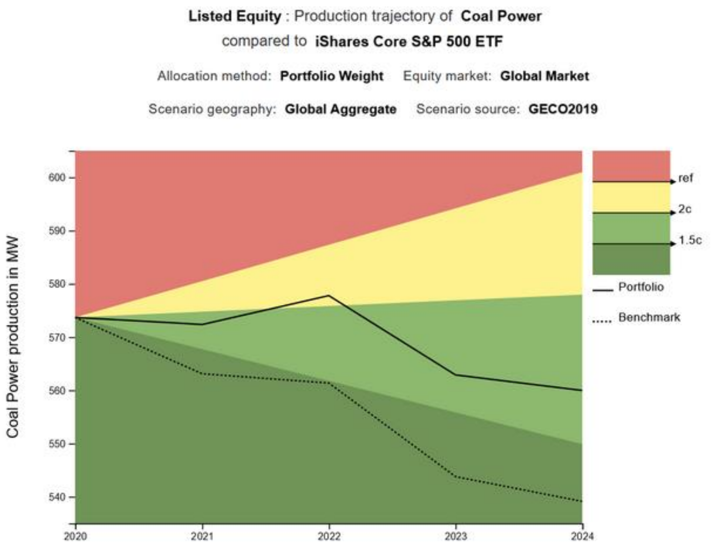
ESG Integration - Strategy

Research

3. Scenario Analysis

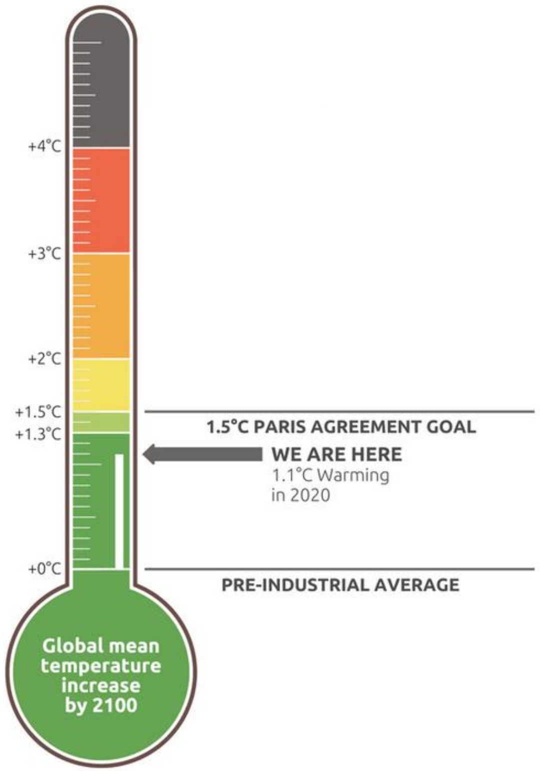
Using publicly available tools or preferred vendor models, investors explore and implement climate scenario analysis.

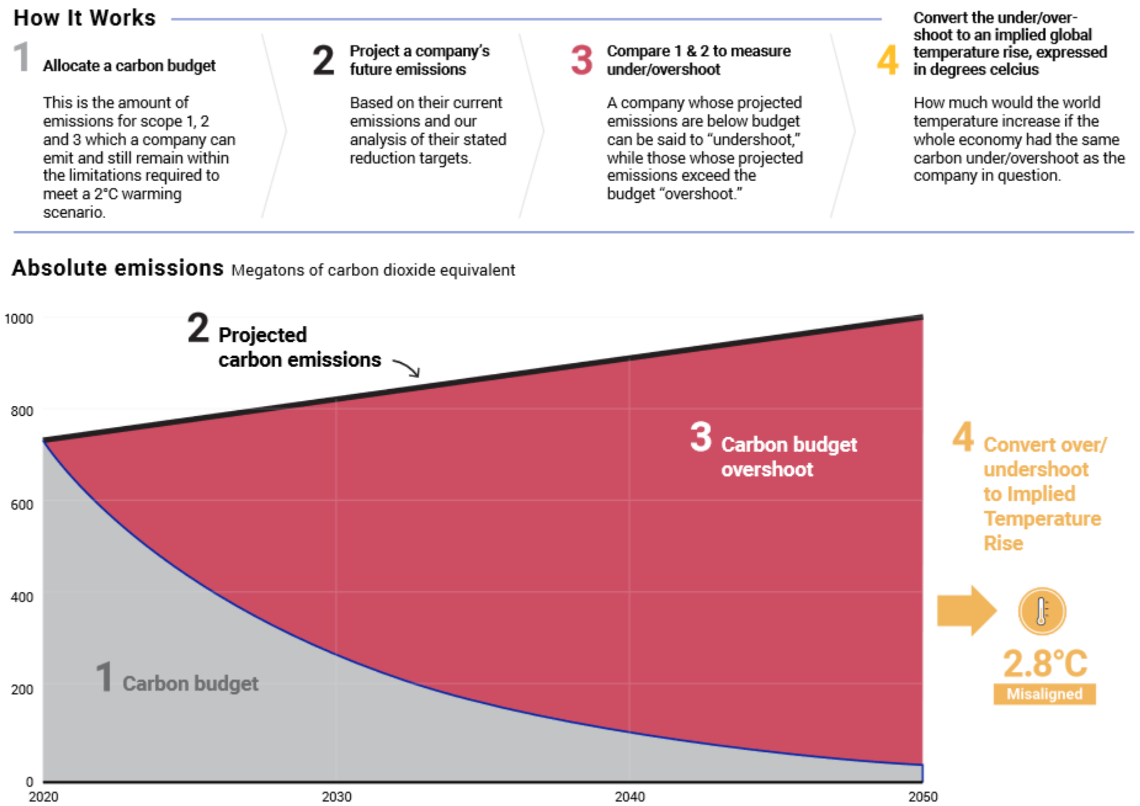




ESG Integration - Strategy

Forward Looking Metrics: Implied Temperature Scores / Temperature Alignment Score



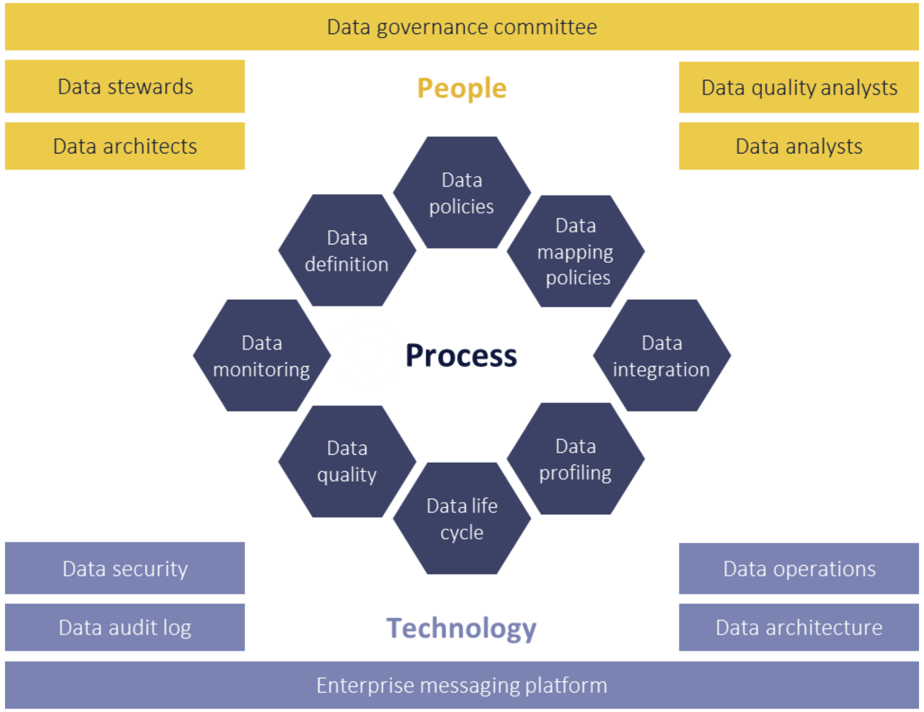


Source: MSCI - Climate Risk
https://www.msci.com/our-solutions/climate-investing/net-zero-solutions/implied-temperature-rise

ESG Integration - Operations

Data Management

- ESG investing adds further complexity to the operating model and data platforms need to be robust enough to handle this.
- Asset managers are incorporating their own in-house ESG beliefs and are reliant on their data platforms being able to aggregate this with external sources to bring together the full ESG picture.

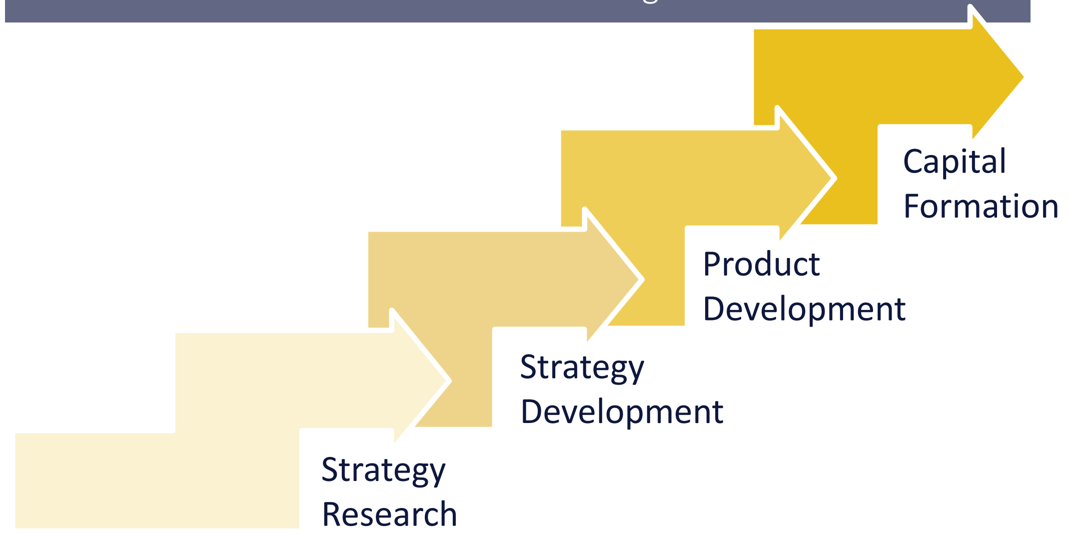


ESG Integration - Strategy

Product, Sales & Distribution

ESG Product Development Objective & Roadmap

Asset managers are evaluating additional opportunities to deliver dedicated ESG-focused investment strategies to their clients



In a J.P. Morgan Capital Advisory Group report from Dec-2020 that surveyed over 300 institutional investors and hedge fund managers-

22% of respondents polled either to have or are planning to launch a thematic ESG fund

Product Type & Characteristics

1. Exclusion or norms-based screening
2. Negative screening
3. Positive or best-in-class screening
4. ESG tilted
5. Factor investing
6. Thematic investing

Examples of thematic funds:

i. Carbon intensity
ii. Renewable energy
iii. Gender diversity
iv. Sustainable agriculture
v. Waste management

ESG Integration - Strategy

External Mandate Management

1. Mandate Requirements & RFPs

- Developing mandate ESG requirements
- Creating RFPs for manager search

2. Manager Selection

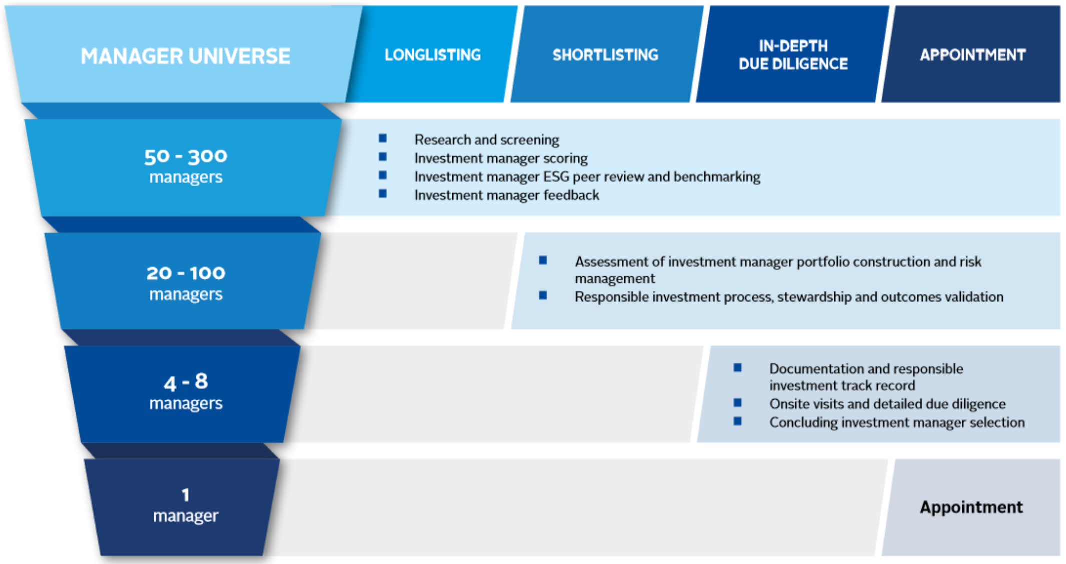
- Longlist of managers
- Shortlist of managers
- In-depth due diligence

3. Manager Appointment

- Embedding ESG requirements into legal documents
- Sample model contracts

4. Manager Monitoring

- Identifying minimum reporting disclosures
- Considering asset class-specific reporting



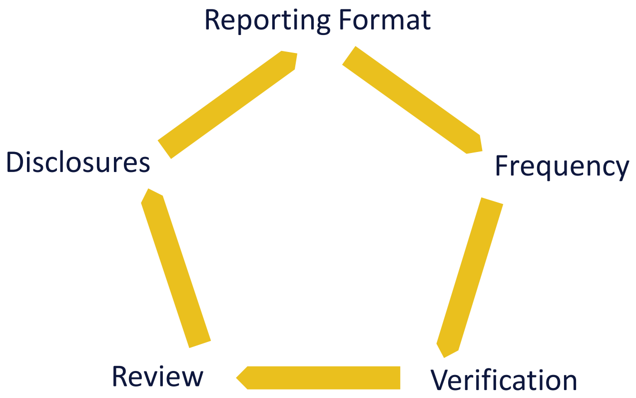
Transfer mandate requirements into legal documentation

Agreement on terms and conditions

Legal review of documentation

Approval process

Signing of the Investment Management Agreement or equivalent



* Based on UN PRI's Asset Owner Guide

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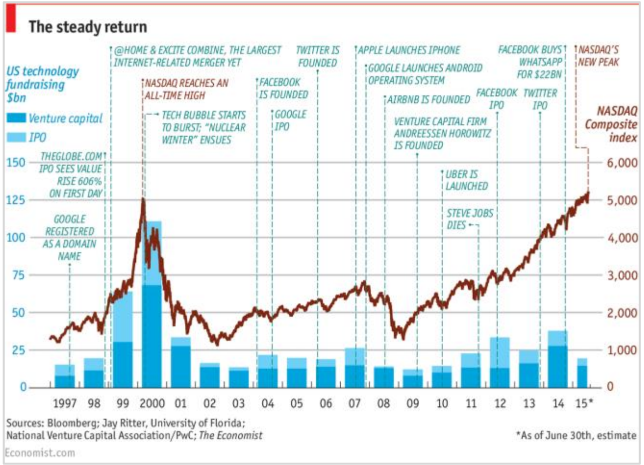
ESG Integration - Strategy

Stewardship and Engagement

- Development of engagement practice into one that's relevant, traceable, outcome oriented and is fully compliant.
- Identifying objectives of engagement specific to the firm / incorporating in policies and practices. Guidance in identification of conviction topics for the firm to focus on in its engagements.
- Defining the Scope and Types of engagements practiced / to be practiced, and identifying Responsibilities thereon. Structuring options for the engagement function within the firm at the appropriate resourcing level.
- Selection of appropriate engagement and stewardship policies for the firm with regard to resources and philosophy of the firm and the practicalities of the firm's investment areas.
- Preparation or adjustment of Responsible Investment policies of the firm to take into account latest regulatory directions.
- Guidance on Voting policy options and follow up / escalation options.

A precautionary tale: short-term greenwashing vs long-term value creation

Dot com bubble



ESG boom

- The Dot com bubble burst led to losses of billions in market value due to speculative bets in companies, products, and asset managers with little to no substance

- However, funded innovations and market leaders at that point also paved the way for long-term sustainable value creation. E.g., the internet and content revolutions, personal computers (Windows), mobile phones and devices (iPod, iPhone)

- Similarly, short-term incentive structures have led to companies and new financial products to raise billions in the name of sustainability

- Asset managers need to recognize the systemic impacts of sustainability but also require comprehensive frameworks to navigate the changing market landscape and recognize potential leaders and greenwashing intentions

What global asset owners are saying

What good is a pension check when it is 45°C outside?

Hiro Mizuno
Ex-CIO
GPIF, Japan

The world is transforming at an unprecedented rate, and to an unparalleled extent. The global investment community is in a period of great risk and great opportunity

Chow Kiat Lim
Chief Executive Officer
GIC, Singapore

Our goal can't only be to generate returns to fully fund pensions, we must make those returns sustainable into the future. We're trying to do both, which is tough

Chris Ailman
Chief Investment Officer
CalSTRS, USA

What good is a net zero portfolio when the world burns around you?

Andrew Fisher
Head of Portfolio Strategy
Sunsuper, Australia

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"Yes, the planet got destroyed. But for a beautiful moment in time we created a lot of value for shareholders."

The New Yorker. Tom Toro cartoon published in 2012.

Thank you

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