Integrating ESG

Sustainable investing techniques and implications for performance professionals

invArtis
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.
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

Focus & Intent

Portfolio Construction
Scenario Analysis
Stewardship Efforts
Fundamental Analysis
Governance & Policies
Third-party thematic research
ESG Tilt / Positive Screen
Third-party scores
External & reporting

Integration Level

Low
High

ESG Due Diligence
Proprietary ESG Scores
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Regulatory guidelines requirements are comprehensive

- **ESG integration level**
  - Low
  - High

- **Focus & intent**
  - External & reporting
  - Internal & operational

- **Governance & policies**
- **Fundamental analysis**
- **Stewardship efforts**
- **Portfolio construction**
- **Scenario analysis**

- **Third-party thematic research**
- **ESG-tilt / positive screen**
- **Proprietary ESG scores**
- **ESG due diligence**
- **Negative screening**

*Where deemed FINANCIALLY MATERIAL*
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.

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

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Third-party scores

Understanding underlying methodologies

<table>
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<tr>
<th>Datapoint Name</th>
<th>Definition</th>
<th>Data Type</th>
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<tr>
<td>Affordable Housing Overall-Revenue Percentage</td>
<td>The overall % share of total revenue coming from Affordable Housing</td>
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<tr>
<td>Affordable Housing Overall-Level of Involvement Range</td>
<td>Overall level of involvement range for the indicator</td>
<td>String</td>
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<td>The overall % share of total revenue coming from Energy Efficiency</td>
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<td>Overall level of involvement range for the indicator</td>
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<td>Financial Inclusion Overall-Revenue Percentage</td>
<td>The overall % share of total revenue coming from Financial Inclusion</td>
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<td>Overall level of involvement range for the indicator</td>
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<td>Green Buildings Overall-Revenue Percentage</td>
<td>The overall % share of total revenue coming from Green Buildings</td>
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<td>Green Buildings Overall-Level of Involvement Range</td>
<td>Overall level of involvement range for the indicator</td>
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<tr>
<td>Green Transportation Overall-Revenue Percentage</td>
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<td>Adult Entertainment Production Product Involvement</td>
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<td>Adult Entertainment Distribution Product Involvement</td>
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<td>Binary (yes or no)</td>
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<td>Alcoholic Beverages Production Product Involvement</td>
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<td>Alcoholic Beverages Related Products/Services-Product Involvement</td>
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<td>Alcoholic Beverages Retail Product Involvement</td>
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<td>Binary (yes or no)</td>
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<td>Scope 1</td>
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<td>Numerical</td>
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<tr>
<td>Environmental Management</td>
<td>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</td>
<td>String</td>
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<tr>
<td>Air Travel Fuel Efficiency</td>
<td>(1) Total fuel consumed, (2) percentage alternative, (3) percentage sustainable</td>
<td>Numerical</td>
</tr>
<tr>
<td>Selling Practices &amp; Product Labeling</td>
<td>(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</td>
<td>Numerical</td>
</tr>
<tr>
<td>Selling Practices &amp; Product Labeling</td>
<td>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</td>
<td>Numerical</td>
</tr>
<tr>
<td>Transparent Information &amp; Fair Advice for Customers</td>
<td>Description of approach to informing customers about products and services</td>
<td>String</td>
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</tbody>
</table>
How can performance and attribution professionals help?

ESG Performance & Attribution Analysis

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

Climate Related Risks

- Transition Risk
  - Policy & Legal
  - Technology
  - Market
  - Reputation

- Physical Risk
  - Acute
  - Chronic

Invested Asset

Present Value$_1 = \sum_{n=1}^{t} \frac{\text{Cash Flow}_n}{(1+i)^n}$

Stranded Asset

Future value impaired by Transition Risks

Present Value$_1 >$ Present Value$_2$
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, Asset class nuances
  - Portfolio Management: Asset allocation, Portfolio construction
- External Mandates
  - Asset Manager Engagement: Mandate requirements and RFPs, Manager selection

Non-Investment Areas
- Risk Management
  - Ongoing monitoring
  - Scenario analysis
  - Risk measurement & budgeting
- Stewardship
  - Proxy voting guidelines
  - Investee engagement
- Disclosure
  - Investors
  - Regulators
  - Intl. standards
- Operational Model
  - Data management
  - Organisational structure
  - Technology infrastructure
Climate risk management

1. Net-Zero Transition Plans & Carbon Footprints

- Determine the overall portfolio carbon footprint and intensity
- Automate disclosure requirements for all stakeholders
- Track progress against an updateable baseline
- Create a Portfolio Decarbonization Roadmap
- Prioritize portfolio companies for decarbonization
- Identify priority decarbonization actions
- 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
**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

*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.*
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 organization will review the policy
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.

- **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

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.
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

**How It Works**

1. **Allocate a carbon budget**
   - This is the amount of emissions for scope 1, 2 and 3 which a company can emit and still remain within the limitations required to meet a 2°C warming scenario.

2. **Project a company’s future emissions**
   - Based on their current emissions and our analysis of their stated reduction targets.

3. **Compare 1 & 2 to measure under/overshoot**
   - A company whose projected emissions are below budget can be said to “undershoot,” while those whose projected emissions exceed the budget “overshoot.”

4. **Convert the under/overshoot to an implied global temperature rise, expressed in degrees Celsius**
   - How much would the world temperature increase if the whole economy had the same carbon under/overshoot as the company in question.

**Source:** MSCI - Climate Risk

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.

- Exclusion or norms-based screening
- Negative screening
- Positive or best-in-class screening
- ESG tilted
- Factor investing
- Thematic investing

Examples of thematic funds:
- Carbon intensity
- Renewable energy
- Gender diversity
- Sustainable agriculture
- Waste management

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.
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

**Reporting Format**
- Frequency
- Disclosures
- Review
- Verification

*Based on UN PRI’s Asset Owner Guide*
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

- 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

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

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

Hiro Mizuno
Ex-CIO
GPIF, Japan
“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.