ESG: BECOMING MAINSTREAM

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

Mamadou-Abou Sarr
Northern Trust

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Dirk Enderlein
Wellington Management

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BY HOWARD MOORE

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

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

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

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

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

ESG Integration: Not Just An Equity Story

There is a tendency to see ESG methodologies as only being relevant to equity investment. In fact, they are useful and can applied in fixed income portfolios too.

Environmental, social responsibility and corporate governance (ESG) principles are well-known themes in the equity markets, where they have attracted loyal disciples among individual and institutional investors. But how about in fixed income? ESG methodologies are every bit as relevant and effective in debt as they are in the share markets.

"We think it is very important to understand that ESG is not just an equityconsideration," says Edith Siermann, managing director and chief investment officer for fixed income at Robeco. "Often -people think that ESG only has to do with voting and engagement, and is just something that can be applied on the equity side. We believe there is no difference in applying it to fixed income."

Siermann says ESG is gaining momentum in fixed income in the Netherlands, France and Scandinavia, and is attracting increased interest in the U.K. and Asia. "You see differences among regions and institutions, but the trend is there, and it won't reverse," she says.

As with the equity markets, Siermann says, investors have a choice about whether to make an ethical position the heart of their methodology or to take a financial approach, within which the sustainability of an individual corporate strategy is part of a broader assessment around an investment decision. "We truly believe that companies that take sustainability into account deliver better performance," she says. "But if you immediately exclude companies that are not sustainable from your universe, you miss the chance of discussing an improvement with them and also miss out on any potential gains if changes are implemented."

This is central to the Robeco approach to ESG, in two respects. First, "we believe in an integrated approach," says Siermann. "That means seeing sustainability as a long-term driver of change in countries and companies, that can add to long-term performance. Sustainability is considered as one of the value drivers in our approach to investing and is therefore fully integrated into the process. Sustainability is an integral part of the world we live in and should not be considered a separate element; it should be integrated at the company level as well."

Second, rather than simply screen out companies and ignore them from the outset, Robeco prefers to look at what a company could do. "We have a strong belief in engaging with a company," Siermann explains. "We actively talk with them about what we think they should improve on the sustainability side. It's an important element of our approach." She says companies are surprisingly willing to talk about sustainability. "In general, they are receptive, and keen to hear from you."

Another differentiator at Robeco is quality of research. RobecoSAM, part of the Robeco group, accumulates information on more than 3,000 companies specifically related to sustainability which focuses on industry/country-specific issues that drive the long-term growth and/or profitability. "The challenge is to make sure you get the right data from an investment point of view," Siermann says. "A lot of sustainability information might be interesting but not relevant to making investment decisions."

RobecoSAM helps Robeco form intelligent decisions, not just on corporate debt but on a sovereign level, too. It has an in-house country sustainability ranking, which is incorporated into the investment process. Analysts, researchers and engagement specialists work together to establish just how an issuer's ESG behavior fits into an assessment of the prospects for that company's or sovereign's securities.

Edith Sierman, managing director and chief investment officer for fixed income, Robeco

The awkward question all ESG equity professionals are asked is whether their efforts help or hinder performance. The question is equally relevant for fixed income. "ESG very much helps," Siermann says. "There are all sorts of ways that sustainability plays a role. If you don't know what is happening in terms of a company's sustainability strategies, then you don't have all the information you need to assess that company's risk and potential. You are missing out. The risk-return profile improves if you can incorporate that information."

As a practical example, a sovereign ESG ranking helped Robeco identify an opportunity in Ireland, where a fund manager increased investments partly because of improvements in governance and transparency of policymaking. The same methodology tells Robeco not to be tempted by Greece, because that country's ESG score is not improving. Siermann says, "Because we don't see the score picking up in the same way that it did in Ireland, that holds us back from stepping into the Greek bond market, even though some investors would think that it is priced relatively cheaply and therefore this is a good moment to get in."

There are challenges in the approach — quantifying the impact of ESG from an investment perspective is an obvious one — but the trend is clear. "Sustainability and ESG integration will be increasingly important," says Siermann, "and investors must be part of this evolution." ■

For more information please visit robeco.com/sustainability

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

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

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

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

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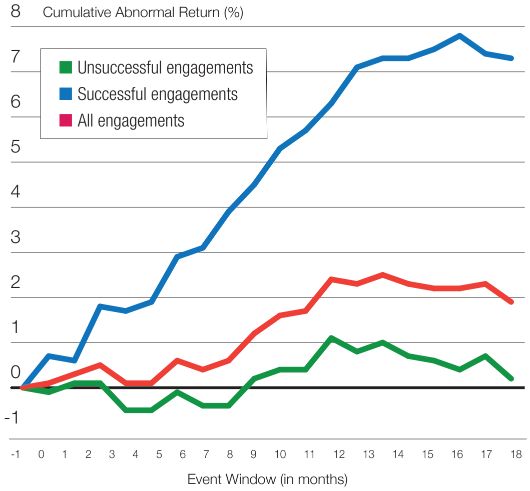
Better Performance Follows Successful ESG Engagements



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

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

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