Responsible investment

Investing for impact

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Investing for impact

Ethical investing is not what it was. The days of investors simply looking to dodge exposure to tobacco, armaments and oil companies are long gone. Ethical investing has evolved beyond avoiding industries that harm the world to one that looks to make a positive impact on society.

Responsible investing, or environmental, social and governance (ESG)-focused investments, is moving into the mainstream. What would have once been dismissed by fund managers under pressure to pay members' pensions is now seen a driver of performance.

Hermes is just one institution that is pushing a fund meeting ESG criteria, relating to areas such as carbon emissions, recycling, good employee relations, diversity and providing rewards to management that reflect the performance of the company. The Hermes Global Equity ESG Fund was launched in 2014 and in the past three years has generated a cumulative performance of 21.3% compared to the 16.7% recorded by the MSCI World AC Index.

So ESG is changing the stock picking process. Those promoting ethical investing say that risk-reduction is an attraction, believing that avoiding badly behaving companies could create more sustainable portfolios.

There are issues. A survey by BNP Paribas in May highlighted that although almost half of asset owners intend to double the value of their ethical investments in the next two years they have concerns that data quality, the effectiveness of the analytical tools available and costs will halt their progress.

Performance has to be a core driver of an asset manager's remit. If the return is not there then pensioners will not get their money. However, academic studies and individual fund returns are showing that a responsible investment strategy and a positive performance are not mutually exclusive.

We brought together asset owners and managers as well as advisers to discuss how attitudes to responsible investing are changing and the impact ESG metrics are having on returns for pension funds. The debate starts on page four.

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Robert De Guigné

“Clients are asking for the impact metrics of their portfolio. It’s not only about returns; they want to understand what their money has been used towards.”
Robert De Guigné

What are the main forces currently driving investors’ attitudes to responsible and impact investing?

Renato Guerriero: When we look at the investment industry today, it can be likened to the automotive industry. A few years ago most people would buy a car based on its technical capabilities speed, power and also status; nowadays people are looking more towards safety, efficiency, the CO_2 impact. And the interesting thing is that they are prepared to pay a premium for these new criteria.

The same thing is happening in the investment industry. Investors are looking past ‘outperforming a benchmark’ and simply achieving returns. They are increasingly factoring in risk mitigation from a more holistic perspective, limiting their reputational risk, the impact of their investments on the environment and climate concerns. These items are very high on the agenda of many asset owners.

Bob Hymas: Can I just pick up on that analogy though as Tesla now has a bigger market cap than Ford. Why are people buying Teslas? Is it because they are electric or is it because of all the other gadgets and sophistication that they bring to the driving experience? You can debate that; it’s relevant, because what you heard across the industry and at pensions conferences over the last two or three years was almost an insistence that pension schemes should invest with ESG as being the priority and they should be thinking about the environment. To me it’s always about economics first and then ESG. ESG is part of it, but actually what you’re looking at is economics. Does it suit the pension scheme, what are its objectives, how does investment fit in with it? Rather than going down a mandated approach that x% of the portfolio needs to be in an infrastructure fund or carbon neutral or renewables.

Edward Siegel: Unless somehow that’s something that the pension holders themselves have expressed a desire for, I agree it shouldn’t be mandated. But what we often hear is that the individuals who are actually benefiting from these plans, if given the choice of allocating a certain amount of their portfolio to social impact investments, or certainly so-called responsible investments, they would say, “Well of course; I don’t want to invest irresponsibly”. But I think it’s difficult for the managers to hear those individual voices sometimes.

Julien Barral: We’ve heard that members were putting pressure on trustees or managers to evolve and we’ve seen some clients considering low carbon as a first step, because they have pressure from the actual members wanting to shift the portfolio.

Robert De Guigné: It’s very different in each country. I think there are four main reasons driving institutions towards ESG. First, regulation, because the regulators are moving pretty quickly. Second is risk, particularly on the reputational side for a pension fund; it’s very important to save their reputation and for foundations or other institutions, it’s also very important for them. The third reason is values, now people are increasingly writing down a code of ethics or charters to define their values and they want their investments to be related to these, so values built out of the ESG that aren’t founded in pure finance. And, the fourth reason is all about long-term returns.

Hymas: I agree the economic argument is that if you want sustainable investment which is what pension schemes are in the long-term game for, then ESG becomes increasingly important and I think it gets there through natural development and through other regulation outside of the pension scheme environment, rather than insistence that the pension scheme is instructed and mandated to invest. With something like Tesla, to go back to that, it isn’t because everyone suddenly wants to go out and buy an electric car, it’s because actually the electric car meets an awful lot of the requirements of a car but also is the future and people start to see it as the future and the price becomes more appropriate and that’s the equivalent of the long-term return.

David Russell

David Russell: I think that’s the critical starting point for a UK pension fund; this has to be based on financial returns and that’s where we start from, our fiduciary responsibility. There will be differences in different markets around the world because they have a different fiduciary framework, but from a UK perspective, the first thing we have to do is make the returns to the pension fund. Our view is that integrating ESG information into our investment decision making process will help us do that and that’s why we play a role in responsible investment in the USS and across the UK.

We have seen HSBC and NEST implement a carbon tilt in their default funds. How much of a role does member pressure play?

Hymas: I struggle slightly with the idea of pressure from the membership. If the trustees listened to every member’s individual preference, it would be very difficult to make decisions. I accept that if it is a membership as a whole, then it’s difficult to ignore, but ultimately, and I know the response isn’t liked, trustees have got a responsibility to achieve a certain return within risk parameters; that is what the objective is.

Russell: Members may say they want to invest their money in ethical funds, in responsible funds, but when they are often given the choice, they often default to the default fund. So when people have the option, particularly in DC which USS has, they frequently don't put money into the ethical fund, they just go with the default.

USS has got member groups that have put pressure on the scheme to look at issues like climate change, defence companies and tobacco. It's a rather large group within our membership but it's still only a couple of thousand out of a 350,000/400,000 total membership, but we do take it seriously and we do respond to every piece of contact we have with our members.

Trevor Allen: I think we sometimes have to decouple different issues in ESG. Sometimes we just muddle everything together in ESG as all being equally weighted and there are certain parts of it that you can make an immediate impact on. I think sometimes financially it makes more sense modelling-wise to look at the transition of low carbon and that's what we were talking about with Tesla. Sometimes there's more of an impact from the end investor that makes a bit more immediate sense when we're dealing with companies that have human rights issues going on, etc. So is it right to invest in a company where they violate typical standards? These issues could have balance sheet impacting implications on the company itself in to the future.

It seems that divestment is a last resort approach for many investors with engagement the preferred route. Do you agree?

Hymas: I think it depends on the size of the scheme because there are 9,000 defined benefit schemes in the UK; a lot of those are relatively small, working through pooled vehicles, and so how much opportunity do they really have? I think trustees need to create an understanding. How much they can do about it at the moment is hard to say; larger schemes can but if I was to use the example of the smaller scheme I'm working with, it's the last thing that's going to be on their mind at the moment; they've got other issues they need to deal with.

Russell: We have actually been engaging for a number of years now by ourselves. We manage our own assets, the vast majority of our public equities, for example, so we take a very active role in stewardship – and that's been the policy since 1999. Getting back to this fiduciary question, we don't believe that we are able to divest on non-financial grounds if you look at what the Law Commission says.

Amandeep Shihn

Is engagement taking place on a standalone basis, or are investors grouping together?

Russell: Over the years, USS has been involved in a huge number of collaborations around engagement with companies on a range of issues. We do [group together] and as an example, in Japan USS works in collaboration with other UK pension funds, one of the APs from Sweden and a Japanese asset manager to support an engagement function. We do engage directly with Japanese companies, we have a chap over there who can do it.

Amandeep Shihn: You have a certain mission, which is to deliver financial returns to all the beneficiaries and there is an extra financial part to that, in that you want to engage to create a better investment opportunity set to develop those returns. We think that's fair for all asset owners to have that mission


Renato Guerriero

which is comprised of a financial and a non-financial part and the non-financial part can come down to engagement but depending on values and beliefs, that could also be divestment but that needs to come from the asset owners themselves. That needs to be very much a beliefs based thing and they need to understand what the potential implications of that divestment programme are in terms of their broader financial mission, because the two are intrinsically linked.

Russell: That's not the reality; it would be nice if it was but that's not the reality we live in and there is still a block in many schemes, in many asset managers, that says, "These issues are not material to an investment decision; it's ethical investment therefore we can't do it and therefore we won't do it", that's the world we still live in. I think it's moved a lot over the last 15 years, but there is still a set of beliefs out there that doesn't take these in to account and so I suspect the reason we're having this panel is because there's a part that is raising the interest, raising awareness.

Shihn: I agree, the reason we're having this is because we're in that process of transition and investor action and investor decisions compounds it over time. So, a bit of a competitive nature between individuals and between organisations; you see someone doing something, you see someone else talking about it, you might raise it, that raises investor action and there is perhaps a part of the universe which still thinks of ESG and sustainability as being ethical or purely exclusions, but I think we're starting to move away from that and certainly the discussions I'm having with asset managers is trying to help them understand that that's not the case.

Hymas: I absolutely agree. You think about the oil majors. Yes, they're in a carbon fossil fuel intensive industry but their businesses are changing, so actually your sustainable investment can stay with an oil major because it is moving away from oil; it is recognising what the alternatives are and what the future is.

We're talking a lot about returns, but what about the impact? ESG is also about creating a positive impact so if it's just making returns and forgetting the impact are we're missing something?

Siegel: I think a lot of pension managers would argue that it doesn't matter, that it's their fiduciary respon-


Bob Hymas

"I agree the economic argument is that if you want sustainable investment, which is what pension schemes are in the long-term game for, then ESG becomes increasingly important."
Bob Hymas

sibility to get maximised return for the risks taken.

De Guigné: That's what we've been doing for 50/60 years at Lombard Odier IM.

Siegel: I am not at all surprised by what I hear from people from the pension fund industry, because I've had some very brief meetings with pension managers over the last couple of years and you have this issue of fiduciary responsibility; it is what it is. But, I also feel that something is missing here; these are value judgments and I think you're absolutely right that we're not going to get away from the fact that the world relies a great deal on fossil fuels to this day and some of the bigger businesses are trying to do something about that, but I also think when you use the term "firms behaving badly"; why would you invest? Who would invest in a firm that's behaving badly? Again, that's a value judgment but I'm quite sure that each one of us, given our own savings, if given the option of not investing in a business that's behaving badly, to be defined and the fact that you may lose a little financial return if you choose not to invest in those businesses. I'd like to believe that we'd all say, "Well you know what, I'm willing to give up a little bit of return, because I don't want to invest in a business that's behaving badly".

Allen: I think the sustainability is part of it and that's why we're having this conversation today is because we need a framework to be able to transition to this socially responsible investing and we don't have that today. People need to understand that if we take a view on tobacco companies or we take a view on labour issues, we take a view on corruption and shareholder rights, these all have an impact on a company and how we want to invest in terms of our ethos, but also in terms of risk in that company for the future.

We're able to incorporate it using a smart beta analysis, because we have all this great computer technology now. I think we're sitting at a crossroads of 1) we have the technology to get through this, but 2) I think the millennials and the generational changes are really coming in to play now and people are asking different questions about investments because people are better educated about investments in general.

Guerriero: I think one force we totally forgot to mention is this pressure coming from governments in order to make more resources available for everything that is climate related. If you think about the development of green bonds, this is pretty much coming from the top-down. With COP21 in Paris last year and the Sustainable Development Goals, pension plans and asset owners are more likely to consider ESG issues within their fiduciary duties. Institutional investors ask themselves how to support the transition to a framework where climate risk is rightly taken in to account.

De Guigné: Clients are asking for the impact metrics of their portfolio. It's not only about returns; they want to understand what their money has been used towards.

Siegel: We hear this a lot from the wealth managers. For the pension managers it's more challenging but the wealth managers have a lot of their clients saying, "You know what? I'm interested in this impact investing thing, this social impact thing, I'd be happy for x% of my portfolio to be put in to anything like that that you can recommend". Because they don't have very much to recommend and that whole positive impact segment I think it lacks scale.

De Guigné: I met with a wealth manager recently in Switzerland and he said about ESG, "Look, the average age of my clients is 80 years old, so they don't care, but their sons and daughters, they are very, very careful" - so this switch is happening, as the wealth is going to the next generation who is aware about those issues.


Edward Siegel

Shihn: The Global Impact Investors Network IRIS metrics go at least some way in creating key performance indicators for measuring impact across different asset classes, different industries and those are financial and non-financial. So, while there isn't necessarily a consistent framework yet that everyone uses, I think that is at least a great starting point which can be built up from and we can measure listed equity impact using these metrics.

To what extent does this need to be driven from the top down, from government?

Hymas: There's always that threat that the government can regulate. I think the way it's tended to happen in the past has almost been to incentivise by providing subsidy and support for wind farms and that sort of area; again very thematic but that was a big growth area because it had a good profile. But, then the subsidies changed, so that's always going to be a concern; we're looking for the long term. Where government can provide the support is actually providing a constant and known support for some of these projects. That is, I think, a better role, rather than this threat of regulation which doesn't help pen-

sion schemes because every pension scheme is different, has different objectives, different beliefs, which comes back to the stewardship.

Allen: Governments are trying on the back of the COP21 to say, "Let's try and limit the rise in the temperature to 2 degrees". Where there are large scenarios like that where everyone gets behind, the governments can do two things; one, they can try to make a systemic change in climate – rising the Earth's temperature in this case but also helping to mitigate risk in pension funds and what we're seeing is French regulation, that's what it's attempting to do there. It's saying that, "We want to adhere to what we agreed at the COP21 but we also want to have our pension funds and various different investors look at scenario risks; where we transition to a low carbon environment, what kind of risk is that going to bring in terms of my investment, in physical risks but also transitional risks to the actual business models that they have there?" But, what they haven't done is actually provided a comprehensive manner for how to do that.

Guerriero: I don't think the government will outline the risks of not moving to a low-carbon economy actually; they'll leave the market to do it.

Are we seeing ESG integration in private markets?

"I think the sustainability is part of it and that's why we're having this conversation today is because we need a framework to be able to transition to this socially responsible investing and we don't have that today."

Trevor Allen

Guerriero: Private assets are arguably a space where one can easily make an impact on the economy and society. What I've noticed over the last few years is that people who are going in to private assets also want a strong ESG filter... Real estate, for example, can have a big positive social impact. The matter is how do you make sure that the whole value chain adopts procedures and practices that are ESG compliant especially in the realm of picking providers, paying intermediaries and/or respecting health and safety regulations.

Russell: I would say having been investing in private markets since 2007 I think it will be mainly in private equity. So, we put in place our team in 2006 and started investing in private equity and over that period there's been a significant evolution in how the sector is addressing ESG issues, from never having heard the term before, to getting to the point where you get fund documentation, there already is a copy of the ESG checklist filled out with all the answers to the questions.

Are we seeing ESG being implemented across the portfolio, across asset classes?

Barral: From the clients that we had, we talked to before, it was a niche or they may have had an ethical fund somewhere which they were not happy with and then realised that they could do so much more with ESG. That is a transition to more ESG strategies but actually looking at companies in more detail and engaging a lot more. So, I think the shift is going from maybe somewhere in the portfolio to probably across the whole – private markets, listed equities, bonds.

Hymas: This is about transparency and actually having the awareness, whether it's through the IMAs and the initial engagement with managers, through to the pooled funds and the information actually coming back out to the asset owners, to the pension schemes; does it have enough transparency? I think the answer is probably "no", so it goes back to the point that yes, the investment is probably there, but is the awareness of it? No. If you increase the awareness through the reporting, then it starts to come up the agenda.

Russell: I would say that from my experience, the critical thing is that the silos are breaking down. Over the years it has become much more integrated; I know within USS it has. But, I can remember going in to a large fund manager some years ago now and introducing the corporate governance team to the fund managers because they hadn't met; I don't believe that that would happen now. I think that part of that is about policy makers looking at institutional investors and saying, "2008 was your fault and you'd better do something about it, or we will".

De Guigné: We started in 1997 with a bunch of analysts dedicated to responsible investing, in silo - we were only involved with clients at the end of the allocation process. But today we are involved at the beginning and we participate actively to investment decisions as we sit on the floor with the teams.

Guerriero: In terms of the role that responsible investments are playing in institutional client portfolios, the largest asset owners are leading the way. The ESG principles are embraced at strategy level and these inform all of the subsequent decisions down the value chain. So, large investors have the ability to engage with their consultants and asset managers and to look for solutions that are tailored to their needs across a broad range of asset classes.

Does investing in poorly governed companies really hinder returns?

Russell: Actually sometimes it's good to invest in companies with poor governance, because if that's already in the price, it gives you an opportunity to improve the governance and hopefully improve the value of your investment.

Trevor Allen

Julien Barral

"We've heard that members were putting pressure on trustees or managers to evolve and we've seen some clients considering low carbon as a first step, because they have pressure from the actual members wanting to shift the portfolio."
Julien Barral

So having poorly governed companies isn't necessarily a bad thing in a portfolio, if you're trying to improve that governance.

Siegel: I would hope that governance improves pretty quickly or else you do divest.

Russell: No, we don't, we're long-term holders.

Siegel: Long-term holders in poorly governed businesses?

Russell: Some will be, yes, and some will have poor environmental performance and we will engage to improve them. The world is a complicated place, but if they don't improve and we don't see the value coming out at the other end, yes, we will not invest which is slightly different from divest, because that's a very pejorative word. We like to think of ourselves as active owners, not activist owners and we will work by ourselves or in collaboration with other investors to engage with companies to try to improve governance. It doesn't always work but sometimes it does.

Guerriero: There is now a serious amount of academic evidence pointing to that fact, especially if you take a long term view. I would also like to stress the fact that whenever you engage with companies, very often they are responsive. The dialogue becomes very fruitful and you can achieve good outcomes in terms of changes in corporate behaviour, performance and governance.

"I don't think the government will outline the risks of not moving to a low-carbon economy actually; they'll leave the market to do it."
Renato Guerriero

De Guigné: I think it would be good if we see a little bit more of environmental or social resolutions in the votes because 99.99% is governance issues.
Guerriero: We did our own research and concluded that ESG doesn't have a negative impact on performance. It's just a matter of how to procure good managers who have a robust process and the right knowledge to deliver solid returns. Many came late to ESG and should refrain from window dressing.
De Guigné: I have compiled and crunched about eight years of data. It is only over the last three years that ESG is really creating interest. Large pension plans have signed up to the PRI so there's more pressure on companies. It's important to remain sector neutral, country neutral, currency neutral in the screenings.

Presumably then, an active approach to ESG is preferable?
Shihn: It comes down to the client's mission and values and if they think that active managers can deliver what they're looking for, then there's no reason why you can't employ active managers. But if they don't, then you can look to passive or semi-passive to provide that solution. This is cheaper, but when you incorporate ESG filters then these things are charged at a premium, so on a risk-adjusted basis, for what you get, a lot of ESG "strategies" that are run by passive managers, tend to be quite expensive.
De Guigné: I think we are now beyond this debate - ESG is playing a central role in the investment philosophies. We started implementing actively with the Generation Fund in 2007 and for two years now, in our systematic strategies. This shows the move from the margins to the mainstream.

How do you identify managers that deliver credible and robust ESG?
Shihn: So, the approach we take is dependent on the asset class and the investment approach of the manager; there is no point comparing a quant manager who turns around their portfolio five times a week with a long owning buy-and-hold active manager, in terms of what they're trying to get out of it; their approaches to investing are going to be very different, both can be very valid but they'll be very different. And, the same way across asset classes, looking at private equity versus equity is going to be different at looking at real estate versus listed infrastructure is going to be very different. We don't have a separate ESG rating on managers; we have a separate tool that focuses on these things but we don't attach a separate rating to it. If they have engagement teams, they have stewardship teams; let's speak to them, what have they done? How have they acted? Let's look at their voting histories.
Barral: We do it in two stages effectively, so more top-down looking overall at what the company is doing, do they have a policy, do they sign up to UN PRI? But, for UN PRI we need to go deeper; do they actually have a good rating? Do they sign up to other things? And then obviously on the investment side, under-

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Edward Siegel


Robert De Guigné

ESG: From the margin to the mainstream

By Trevor Allen, Product Manager – Risk and performance, BNP Paribas Securities Services

Heralded as a 'new lens' into a company's performance and work culture, ESG metrics (Environmental, Social and Governance) are fast gathering momentum as a new way of assessing investment risks.

ESG data measure how well a company is performing as a steward of the natural environment, in its relationships with staff, suppliers, customers and the wider community, and in the way it is led.

Many investors now recognise that ESG factors can affect the performance of their investments, both in terms of risks and returns, amid evidence showing that companies with strong ESG scores can deliver better financial returns. Indeed, in a wide ranging survey we conducted of more than 460 professionals from asset manager and asset owner companies*, we found that 80% incorporated ESG data into their investment process in some way.

ESG data can also highlight potential risks such as those related to climate change which can directly impact investments, for example by increasing production costs.

Another factor is that the millennial generation is more demanding in wanting to know that their money is being invested responsibly and is not contributing to climate change or supporting corrupt governments.

Investment strategies

The United Nations-supported Principles for Responsible Investment, agreed by 100 investors in 2006, provide a framework that investors can use to incorporate ESG into their decision-making and ownership practices.

The number of signatories to the principles has grown strongly over the past 10 years, and now stands at more than 1,500, including 300 institutional investors.

In fact long term asset owners are a significant positive factor in changing how money is invested. Over recent years we have seen many large pensions funds in particular make commitments to decarbonise portfolios and to divest from other potentially harmful sectors – whether that is related to the environment, health or society.

But it is more than sentimentality that is driving this change. There are now market forces which are shaping investment portfolios. Take fossil fuels – coal and oil specifically – as an example. At COP21 in December 2015 – almost 200 countries pledged to keep global warming to two degrees centigrade above pre-industrial levels. In order to achieve this then substantial amounts of the carbon-emitting fuels already discovered must remain in the ground and these so called "stranded assets" will therefore have no value.

Stranded assets are of deep concern to institutional investors, with their long-term fiduciary duties, and as such many are already rotating their portfolios towards a low carbon economic future.

External forces are also driving change, with governments, regulators and ratings agencies also putting increasing emphasis on ESG reporting.

In December 2015 France became the first country in the world to adopt a law requiring large institutional investors to disclose information about the way they manage climate risk and how they integrate ESG into their investment strategies. Article 173, is due to come into force this June and was heralded by France's ecology minister as "the most advanced and ambitious piece of environmental legislation in Europe, and probably the world".

The law introduces binding energy targets for transport, housing and renewable energy and aims to cut France's energy consumption in halve by 2050 and to reduce its use of fossil fuels by 30% by 2030. Crucially, there is an onus on investors – large institutional investors with more than €500m on their balance sheet – to disclose how they address climate change-related risks, split into "physical" and "transition" risks. They are also required to assess and report on their contribution to international efforts to cap global warming and to supporting France's "energy transition". Meanwhile, the European Union has agreed a directive on the disclosure of non-financial and diversity information that will require large companies to report ESG data.

And in May last year, Standard & Poor's, Moody's and four other ratings agencies announced that they would start including ESG risks in their assessments.

Positive practices

ESG requirements are now increasingly being written into investment and lending agreements, and companies are producing more data to allow potential investors to screen them for ESG factors.

Companies themselves may also insist that their suppliers respect their own standards, with the result that positive practices spread through the supply chain.

ESG measurements cover an extremely wide range of topics. In terms of environment, issues include carbon emissions, energy use, raw material sourcing and recycling. The social component embraces human rights, employee relations, diversity issues, and health and safety. And the governance segment looks at factors such as executive pay, board structure, shareholder rights, and bribery and corruption.

There is therefore a need for accurate, consistent and independent data on a whole range of questions. And investors need sophisticated analytical tools to enable them to integrate ESG into their investment strategies.

It is in this area of data where there is currently perhaps the biggest challenge, and opportunity, for investors and the industry which serves them. According to our recent survey, more than half of those who incorporate ESG into their investment strategies say that a lack of availability of robust data is the biggest barrier to wider adoption of ESG investing.

However, with initiatives such as Article 173 in France and similar legislation likely to be introduced around the world, this is an issue which is beginning to be tackled. Companies will be forced to provide comparable metrics on how they rate against many new targets and will face significant investor, and public, scrutiny if they fail to do so.

The next challenge is to provide meaningful analysis of this data and we are seeing a burgeoning industry in providing this type of analytical overlay. Last year we launched our own ESG Risk Analytics tool, which helps our clients to see how their investments stack up against various factors within the broad category of ESG. For example, a client can clearly see their exposure to certain potentially controversial sectors such as arms, tobacco and alcohol.

But importantly, ESG and sustainable investing more broadly is having a much wider, positive economic impact, creating new demands from the financial industry.

Green bonds – bonds issued to finance the development of climate-related or environmental projects – are on the rise. So are responsible indices, which are made of ESG-vetted stocks, and custom financing solutions.

BNP Paribas recently participated in a major renewable energy financing programme for an Iberian municipality which wanted to upgrade its street lighting to environmentally-friendly LED technology. The wining proposal featured a repayment based on the environmental savings resulting from the new LED lighting.

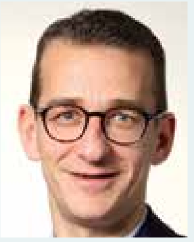
Sustainable finance is not a passing fad: solutions which take into account sustainability factors are increasingly being demanded by corporate and institutional clients.

BNP PARIBAS

*BNP Paribas has commissioned a survey of asset owners and asset managers around the globe in order to understand their motivations and barriers (real or perceived) to integrating ESG into the investment process and their views on what they need to make ESG a success. The report will be published in May. To register your interest to receive the report please go to http://securities.bnpparibas.com/global-esg-survey-2017.html

Sustainable investing: The road to integration

By Wim Van Hyfte – Global head of responsible investments and research, Candriam Investors Group and Fawzy Salarbux – Global head of consultant relations, Candriam Investors Group



Sustainable investing is on an irreversible trend from niche to norm. A rapidly evolving regulatory landscape, the landmark 2015 Paris agreement (COP21) on climate change, the mounting body of evidence supporting the financial materiality of sustainable investing, and the increasing focus on ESG by asset owners are but a few key factors supporting the trend.

Headwinds and tailwinds

There are still, however, some lingering misperceptions and challenges impeding the wider incorporation of ESG across a broader spectrum of asset owners.
One key obstacle is the myth that sustainable investing imposes a compromising trade-off with investment performance, therefore conflicting with fiduciary duties. The kernel of truth within the myth stems from the early adoption, almost two decades ago, of exclusionary approaches that had negative implications for diversification and performance. At Candriam, we believe that a thorough assessment of ESG risks and opportunities is crucial to build an accurate picture of our investments. We incorporate factors, often intangible in nature, that are not typically picked up by traditional financial analysis but which have a long-term impact on performance. There is a growing body of research, from academia and the investment community, supporting the theory that ESG investing does mitigate volatility, limit drawdowns and enhance the risk-return profiles of investor portfolios.
There are also some practical challenges such as the lack of time and resources from asset owners. With more investment solutions and improving standards of reporting, these challenges are being more readily met. Although there is some way to go, a dose of pragmatism can help investors establish a starting point.
The lack of high quality information and a uniformity in definitions add to the challenge of investors to formulate an ESG policy. The formation of the Sustainability Accounting Standards Board (SASB) and the recent EU Non-Financial Reporting Directive from 2017, promoting more transparency on ESG disclosure, will help to alleviate this over time.
Despite these challenges, momentum behind ESG investing is building thanks to innovative investment solutions, robust performance of ESG strategies and increased regulatory pressure.
One of the key implications of the 2015 Paris agreement is that significant investment, averaging $1trillion annually until 2050(1), is required to fund the investment gap to achieve a low-carbon and energy-efficient economy. This creates significant opportunities for the private sector.
Then there are the demographics. US assets invested along ESG principles, between 2014 and 2016, increased by 33% to $8.7trillion(2). Talk is finally translating into action, especially with 'Millennials' more sensitive to the impact of their investments on the society and the environment than their predecessors. Overall, the direction of travel is clear.

ESG integration – which approach works best for you?

At Candriam, we manage over $20bn of assets invested in ESG-related strategies across a broad spectrum of clients and geographies. We observe that each client brings their own beliefs and perceptions to the ESG table. There is no definite, right answer on what is the best approach to ESG integration.
For clients who have significant resources to commit to ESG integration, we see a more rigorous definition and 'hard-coding' of investment beliefs at the strategy level. We have been able to assist in the formulation and implementation of their investment beliefs through tailor-made solutions. For a large European asset owner, we tailored a zero-carbon strategy across their equity portfolio to address changing regulatory environment in France.
For clients intent on incorporating ESG but with less resources, we observe that adopting a pragmatic approach, rather than constantly deferring the decision regarding which approach to use, has worked better in terms of creating the framework and the initial momentum to implement ESG.
The answer to the question is a pragmatic 'what works best for you'.

Our ESG framework

As sustainable investing is an evolving area, it is essential for institutional investors to partner with an investment manager with strong capabilities and experience that is capable of working with clients with different governance budgets. At Candriam, we have built and refined a robust ESG framework which gives us the flexibility to do so.
We have a well-resourced and fully dedicated team of ESG analysts whose sole responsibility is to carry out ESG analysis, without any conflicting financial interests. This maintains the depth and purity of our ESG process. We use a range of proprietary models and external data sources within our analysis which allows to make a holistic evaluation of a company's risk and return profile.
We apply a 3-step process for the relevant investment universe – equities or fixed income - to produce a focus list from which our portfolios are constructed:

1. Best-in-Class analysis

Our best-in-class analysis seeks to positively identify the best or improving ESG companies in their ability to manage the sustainable development issues against their sector peers. We do so from two perspectives: a 'macro' perspective which evaluates the company's exposure to six major long term sustainable development challenges (e.g. climate change, demographic evolution); and a 'micro' perspective which evaluates how each company's policy incorporates stakeholders (e.g. investors, supply chain issues) in its corporate strategy and policy.

2. Norms-based analysis

This stage evaluates how companies comply with the principles of the United Nations Global Compact (UNGC) covering human rights, labour rights, the environment and anti-corruption.

3. Assessment of controversial activities

This evaluates a company's involvement in controversial activities such as armament, adult content, alcohol, gambling, genetic modifications and other activities exercised in oppressive regimes.
Additionally, our engagement takes the form of direct and individual dialogue between our ESG analysts whilst our voting policy favours resolutions consistent with our ESG framework. In 2016 we engaged with nearly 100 companies in Europe, North America and Asia on topics that relate to ESG disclosure and investment decisions making and corporate practices impacting our analysis in more than 30% of the cases considered.

Our solutions-based approach to ESG

Our ESG framework allows us to provide tailor-made solutions across a range of asset classes:

- Global Equities - We combine our ESG process with a robust quantitative process to deliver a diversified portfolio of ESG companies that we believe will outperform over the long-term
- Emerging Markets - Given the heterogeneous nature of the emerging markets universe, ESG scoring has implications for portfolio construction. Our approach adjusts for those imbalances and has delivered strong returns versus the broader indices over the long term
- Global High Yield – With the focus on governance (G) already a strong part of our high yield strategy, our ESG process adds the environmental (E) and social (S) dimensions
- Emerging Market Debt – Our EMD strategy incorporates a strong ESG dimension through its country selection and relative value bets

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Notes: (1) Estimated by the International Energy Agency (IEA); (2) US SIF study

The 100%-Impact Investor

By Robert De Guigné, Head of Socially Responsible Investments and ESG Solutions, Lombard Odier Investment Managers, www.loim.com

What happens when you enhance the focus of your ESG analysis with genuine environmental and social impact criteria? You realise the full potential of ESG, and create the "100%-Impact Investor"

From Ethics to Impact: A Long History of Innovation

At the beginning of the 2000s, some investors decided that they wanted to finance companies that did not merely behave responsibly and sustainably, but also worked on solutions to the world's most pressing challenges. They wanted their capital to be put to work for direct social and environmental impact. They developed the first microfinance funds and impact venture capital strategies. They designed the first Green Bonds. The era of Impact Investing had arrived.

"Going deeper" with impact analysis often takes investors to places where mainstream investors cannot follow: it is easier to monitor the real-world impact of capital allocated to a portfolio of small, private companies, or Green Bonds, than monitor it in the buying and selling of a diversified portfolio of listed stocks. "Getting broader", on the other hand, requires us to integrate impact criteria in ways that do not affect the asset allocation, risk-return profile or liquidity target of our investment strategies. However difficult, we believe investor demand will make this unstoppable. A generational shift will see trillions of dollars transferred from baby-boomers to millennials over the coming decade: they think one of the top priorities for any business should be "to improve society." It's clear to us at Lombard Odier IM that "Getting broader" and "Going deeper" ultimately means the complete integration of impact analysis into mainstream investing, and the creation of the "100%-Impact Investor".

Towards 100%-Impact Portfolios

Even without this generational shift, we see two powerful forces pressing impact into its rightful place alongside responsibility and sustainability. One is regulatory: national and international rules and guidelines for investors increasingly recognise impact criteria.

The second is that investors can already point to 30 years of evidence that ESG analysis helps identify some of the key characteristics for sustainable financial returns. It is reasonable to assume that enhancing that analysis with a greater focus on impact might improve performance still further.

Our own analysis supports this assumption. Like many impact-conscious asset managers, Lombard Odier IM monitors a "Controversy Radar": we looked at the blips on this radar alongside the returns of the 5,000 companies in our database over seven years, and found that whenever a stock jumped from a low category up to the most severe category-four or five controversies, it lost an average of 4.5% in one month (the two weeks before and after its peak controversy rating). Moreover, over the past three years that average loss has jumped to 12.5%*. Simply excluding the bottom quintile of companies based on our ESG ratings halved the probability of a portfolio experiencing a peak in the Controversy Radar. Controversies arise from visible social or environmental impacts, so these results show that companies' ESG scores do correlate to some extent with their real-world impact. But there are plenty of exceptions to make us question whether the full picture is captured by conventional ESG analysis, which assesses companies' organisation and direct operations but doesn't say much about their products.

Think of Total, for example. It scores well in most ESG models, despite the fact that its core product is a leading contributor to greenhouse gas emissions. At the same time Tesla, which has not yet formalised its code of ethics or implemented state-of-the-art governance, gets a fairly poor ESG rating despite helping to revolutionise clean transportation. It is partly to catch such anomalies that we at Lombard Odier IM have introduced a proprietary carbon intensity tracker for our universe of stocks.

But we have also enhanced our ESG approach itself with an additional analytical framework, "CAR" ("Consciousness, Actions, Results"), which looks beyond companies' stated intentions on responsibility and sustainability and into the actions they have taken to get measurable results.

We go further, scoring for "Action" when a company sets up awareness and talent-development programmes for female staff for example, and "Results" if it can demonstrate a consequent increase in women in senior management. This helps identify good ESG practice that is having real-world impact, as opposed to good ESG practice designed to "greenwash" corporate social responsibility reports.

Measuring Performance – the ESG view

E Preserve the Environment (33%)
- Emission reduction
- Natural resource preservation
- Product innovation

S Work for Social progress (33%)
- Respect of human rights
- Impact on communities
- Client/Product responsibility
- Diversity in workforce
- Health and safety
- Training and career development

G Practice fair Governance (33%)
- Board of directors' functions and structure
- Directors' compensation policy
- Shareholder rights
- Strategy against bribery and corruption

Measuring Progress – the CAR View-Lombard Odier proprietary model

C Is the company Conscious (20%)
- Setting general ESG policies
- Participation in and membership of international organisations and workshops
- Marketing

A What Actions are taken? (30%)
- Developing reporting tools
- Implementation of ESG policies in the mainstream business
- Increasing transparency and reporting
- Fitting ESG into the corporate strategy

R What Results are achieved (50%)
- Reducing environmental impact
- Improving social balances
- Improving governance structure

LOMBARD ODIER
INVESTMENT MANAGERS

*Source: LOIM as at 31 May 2017.

Fund managers and exec pay: is the pot calling the kettle black?

Does the asset management community need to take a look in the mirror when it comes to executive remuneration? *Emma Cusworth* investigates.

As the annual furore over excessive executive pay gets underway, there are some important questions about fund managers' own pay scales and structures that warrant close attention. Some of the largest fund managers including Blackrock and Franklin Templeton, have come under fire for high executive pay, which may weaken their role as stewards when it comes to addressing excessive pay at investee companies.

Yet, as the big fund management houses represent an ever-increasing proportion of total asset ownership, their role as stewards for trillions of dollars in clients' money grows in importance. It becomes imperative, therefore, to consider how willing and able the fund management industry is in addressing excessive executive remuneration.

> "Some are perhaps hesitant to be vocal because they are so aware of [high pay at their own firms]."
>
> Stefan Stern, High Pay Centre

FUND MANAGERS UNDERESTIMATE THE PROBLEM

The asset management industry has come in for sharp criticism from some quarters, which may seem unsurprising given the shareholder revolts of previous years have done very little to turn the tide of executive pay.

In 2016, the Investment Association's Executive Remuneration Working Group (ERWG) charged with looking at the issues surrounding executive pay – which included high-profile fund management figures such as L&G chief executive Nigel Wilson, L&G head of personal investing Helena Morrissey, and Sainsbury's chairman David Tyler among others – was lambasted by the director of the Institute of Business Ethics (IBE), Philippa Foster Back, for its failure to recognise the seriousness of the problem of excessive exec pay and the urgency with which it needs to be addressed.

The IA's interim report acknowledged that exec pay is "widely seen as broken" and that the level of exec pay had more than trebled over the previous 10 years even though the FTSE was at broadly the same levels, and was 10% below its then peak. However, Foster Back criticised the ERWG for failing to come up with radical enough recommendations for reforming executive pay.

Meanwhile, according to the IBE, public concern about business ethics increased dramatically in 2016 as less than half of respondents said they believed British business behaves ethically. The level and structure of executive remuneration consistently figures in the top concerns raised by the survey.

Shareholders appear to be increasingly unhappy about excessive executive pay as the number of firms subject to investor revolt increases with each passing year. A poll by the Pensions and Lifetime Savings Association (PLSA) in 2016 revealed nearly 90% of pension funds said company bosses were paid too much.

Those investors may also now be losing patience with the fund management industry upon which they are increasingly reliant to act as stewards.

FEELING THE HEAT

Some of the biggest asset managers in Europe and the US, including Blackrock, Henderson, Franklin Templeton and Schroders, are among those that have been vilified for their high executive pay awards. Top of the list is Blackrock's chief executive, Larry Fink, who earned just under $26m in 2015 – nearly three times the $10m average S&P 500 CEO pay. His variable pay (bonus and share awards) was roughly 30 times his salary.

Although exec pay across the corporate sector generally has been a clear area of focus for investors in recent years, fund managers have largely managed to stay out of the limelight. Pay awards on the scale seen recently have raised questions about whether fund managers are compromised when it comes to engaging with the companies they invest in regarding responsible pay.

Kris Douma, director of ESG engagements and investment practices at the UN's Principles for Responsible Investment (PRI), says: "The issue of alignment in corporate remuneration has been on the agenda for a number of years, but it has not really been on the agenda for fund managers' remuneration. This may have the effect of allowing relatively high remuneration although performance is not that great."

The high pay fund management execs have been awarded impacts their ability to press for changes to remuneration policies at investee companies in no small part because it numbs them to the problem.

According to Stefan Stern, director of the High Pay Centre, high executive remuneration at fund management firms diminishes those managers' negotiating position in the sense that they become "desensitised to the sheer size of the numbers involved".

"This is a systemic problem," he says. "These managers are all earning salaries into six figures with ambitions to earn more. They probably don't recognise how large those pay packets are."

Having employees on remuneration committees is therefore something Stern strongly advocates. "Those employees can then ask the basic questions about why these packages are so large," Stern says. Even though many of those employees will likely be well paid themselves within the fund management sector, Stern says even having those with a five-figure salary will bring a more normal perspective to a committee where others earn seven figures. "That more normal perspective seems to be lacking in the conversation at the moment," he warns.

But high pay also jeopardises managers' willingness to engage. "Although it varies from firm to firm, some are perhaps hesitant to be vocal on executive pay because they are so aware of [high pay at

> “As an investment industry, we must walk the talk on remuneration. Anything we are asking companies to do, we should be comfortable that we are doing ourselves.”
>
> Leon Kamhi, Hermes Investment Management

their own firms],” Stern says.

Blackrock has, until recently, certainly had form in this regard. With $5.1trn in AUM, the firm has stakes in every company in the FTSE 100, but despite increasing numbers of investor revolts on executive pay, the firm has supported pay awards in the vast majority of cases – a majority that has been moving in the wrong direction. In 2015, Blackrock supported 91% of pay awards at the UK companies it invests in, which increased to 92% in 2016. In the US, where high pay is an even greater problem than the UK, it supported 97% of pay awards during the year to the end of June 2015.

Blackrock recently sent a letter to 300 UK companies saying it would only approve salary rises for top executives if workers’ wages increased by a similar amount. This quickly and unsurprisingly sparked accusations of hypocrisy.

After all, one of the most effective forms of stewardship is to lead by example.

Hermes Investment Management head of responsibility Leon Kamhi says: “As an investment industry, we must walk the talk on remuneration. Anything we are asking companies to do, we should be comfortable that we are doing ourselves.”

Hermes recently updated its remuneration principles to push for simpler schemes, appropriate levels of share ownership, a clearer view on outcomes and whether remuneration packages would pass the ‘man on the street’ test. “This applies as much to fund management as any other industry,” Kamhi says. Hermes will also be disclosing its CEO’s pay in its annual report this year for the first time and will provide an explanation for the level of pay he will receive.

With the PRI and PLSA working on guidelines to help asset owners increase the effectiveness of their stewardship, more fund managers could find themselves in the firing line.

PAYING FOR (NON) PERFORMANCE

As with much of the corporate sector, concerns that high exec pay in the fund management sector come despite growing criticism that many are not providing value for their clients.

High pay is clearly funded by high fees, which have become a target for clients and regulators alike. Many fund management firms have seen massive outflows in the last few years as investors have become increasingly disenfranchised with the active management sector in particular. Many fund management houses have not done very well performance-wise over the last year and, as Hermes’ Kamhi says: “It will be instructive to see how pay has changed since last year.”

This is already feeding through for some firms. After suffering outflows of nearly £33bn for the 12 months to the end of September and a fall in profits of roughly one third, Aberdeen Asset Management CEO Martin Gilbert, for example, has seen his pay for 2016 fall by more than a third to £2.5m. This included a 1.4% salary increase, but a 40% cut in his bonus from 2015. Aberdeen also froze salaries for high earners (those earning more than £75,000).

“It will be interesting to see how other firms respond, firstly with performance and then how they adjust pay packages,” Kamhi says. “It is important for fund managers to be able to justify pay and fees to their clients.”

A VICIOUS CYCLE

According to Dan Brocklebank, UK director at Orbis Investments, the core problem behind high pay at fund management houses is that pay in fund management is “only loosely linked to the value-add their clients receive”. “Pay structures at most firms are more sensitive to AUM than performance,” he says.

Why does this matter? Because size is inversely related to performance. In the words of Jupiter vice chairman Edward Bonham Carter: “There is little link between the size of an asset management company and the outperformance a client sees.” He even suggests fund management suffers from “diseconomies of scale”. Himanshu Chaturvedi, managing director at Cambridge Associates, meanwhile says: “Size is the enemy of performance, especially in strategies that can generate outperformance.”

As a consequence, excessive rewards to fund management CEOs based on their ability to gather assets will mean the link between pay and the performance clients enjoy will become ever-more diminished unless pay structures are fundamentally restructured.

THE PROBLEM WITH PASSIVE

The disenfranchisement felt towards active managers has very much benefited firms like Blackrock, whose assets under management are reportedly around 90% invested in passive, index-tracking strategies. But this potentially weakens the fund management industry’s negotiating power even further.

Even if a passive manager strongly objects to pay at one of the underlying companies in an index it is tracking, it cannot simply divest. It is powerless to vote with its feet – the ultimate punishment an investor can inflict on a company.

Companies are well aware of this conundrum, which presents a growing problem as the rush towards passive management continues apace. It has arguably already led to a backwards movement in corporate governance in America, for example, where Snap was able to undertake an IPO by issuing only non-voting shares. This robs investors of their key mechanism for exerting influence or control over the companies they own. Fund management houses had been in uproar at Snap’s plans, and without the reassurance of massive compulsory buying based on its inevitable inclusion in some mainstream indexes, Snap would have found it harder to get away with such a departure from established best-practice.

Add to this the unrelenting pressure on passive managers to cut fees and it is easy to see how the resources they direct to stewardship could quickly start to suffer unless asset owners use their influence to exert pressure on passive managers.

It’s good to see firms like Blackrock taking a more active stance on executive pay, but efforts by the fund management industry to reform the corporate sector will be hindered by the growing passive movement and their failure to lead by example – the pot calling the kettle black, so to speak.

If investors aren’t careful, they could find themselves paying increasingly high remuneration to fund managers as their ability both to act as stewards and to outperform diminishes. Asset owners need to take a more active stance to keep fund managers on track when it comes to executive pay reform. As PRI’s Douma says: “It’s important to look at what asset owners are doing to instruct their fund managers on voting behaviour. The most obvious way to address this problem is for asset owners to collaborate more.”

THE IBE CALLS FOR ‘TOTAL RETHINK’ OF BEST PRACTICE ON REMUNERATION

The Institute of Business Ethics (IBE) has called for simpler remuneration structures with greater transparency and a longer-term focus to address the problem of fairness.

Shareholders should use any new voting powers granted them to promote a “total rethink of best practice”.

Included in the IBE’s recommendations is a suggestion that chief executives should not be eligible for bonuses or pay increases when their company has a pensions deficit and there is no agreement in place with The Pensions Regulator (TPR) on how to resolve it.

IBE director Philippa Foster Back, in her letter to the Investment Association’s Executive Remuneration Working Group (ERWG), says that in every case the remuneration committee should be able to answer the following simple questions:

- Why have we chosen the level of quantum proposed and can it really be justified?
- Can everybody — boards, executives, shareholders — clearly see the value of what is being handed over?
- Will the award stimulate the executives to pursue a long-term strategy that is in the interests of the shareholders and the company?
- Will the broader public be able to see a clear connection between performance and the eventual outcome?

Foster Back’s letter concludes:

“Until remuneration committees can always answer these questions, we will continue to have problems with executive remuneration which feed into rising voter concern with inequality on both sides of the Atlantic.

“We believe the problem is urgent and more serious than [the Executive Remuneration Working Group] report suggests.”

portfolio **institutional**

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Investors and investment consultants are invited to share their opinions and could be offered a complimentary place at future roundtable events. Asset managers interested in joining the panel can secure one of the limited sponsorship packages.

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