ROUNDTABLE: SUSTAINABLE AND RESPONSIBLE INVESTMENTS

For many investors, 2015 was the year that sustainable and responsible investment (SRI) reached a tipping point. Growing concerns about climate change culminated in the Paris climate talks in December, which saw unprecedented engagement by investors and companies alongside policymakers and environment activists. The continuing growth of the Principles for Responsible Investment and other investor initiatives is providing further testament to the increasing acknowledgement of the importance of incorporating environmental, social and governance (ESG) issues into investment management.

But many pension fund executives, trustees and advisors remain unsure whether and how to address ESG risks and opportunities in their own funds. The Pensions and Lifetime Savings Association brought together a group of asset owners, asset managers and consultants to discuss how the SRI industry has emerged into the mainstream, and how pension funds might engage with the issues raised by responsible investment.

ATTENDEES

MIKE TYRRELL
EDITOR, AND ROUNDTABLE CHAIR, SRI-CONNECT

JANE AMBACHTSHEER (JAMB)
PARTNER & GLOBAL HEAD OF RESPONSIBLE INVESTMENT, MERCER

HONOR FELL (HF)
MANAGER RESEARCH ANALYST, REDINGTON

LEANNE CLEMENTS (LC)
RESPONSIBLE INVESTMENT OFFICER, WEST MIDLANDS

MARK MANSLEY (MM)
CHIEF INVESTMENT OFFICER, THE ENVIRONMENT AGENCY PENSION FUND

JENNIFER ANDERSON (JAND)
INVESTMENT OFFICER, PENSIONS TRUST

LUKE HILDYARD (LH)
POLICY LEAD, STEWARDSHIP & CORPORATE GOVERNANCE, THE PENSIONS & LIFETIME SAVINGS ASSOCIATION

DON GERRITSEN (DG)
SENIOR MANAGER, THE PRINCIPLES FOR RESPONSIBLE INVESTMENT SECRETARIAT

WIM VAN HYFTE
PORTFOLIO MANAGER, CANDRIAM

RENATO GUERRIERO
GLOBAL HEAD OF CLIENT RELATIONS EUROPE AND MIDDLE EAST, CANDRIAM

1. THE SRI INDUSTRY IS A VERY DIFFERENT PROPOSITION TODAY THAN IT WAS 10 YEARS AGO. HOW HAS IT CHANGED IN RECENT YEARS?

JAnd: Over the last 10 years we've seen the increasing mainstreaming of SRI and responsible investment, in terms of its profile and the level of awareness of how it can be relevant to investment processes and practices – not only in equities, but across other asset classes as well.

The career history of RI individuals has also changed significantly: more of them have financial backgrounds as well as an interest in sustainability issues. Their profiles, both internally and externally to their organisations, have also increased significantly. One other development I have noticed more recently is the increasing number of CIOs and CEOs willing to stand up and say, "we think responsible investment is relevant, it does enhance our investment process, and we do take it seriously".

The range of products and solutions available to investors has also increased significantly since I first started out in the field 10 years ago. Then, products were much more niche, now we see a whole range.

JAmb: The launch of the Principles for Responsible Investment [PRI] has also played a fundamental role in creating a touch point, setting out six responsible investment principles we can all agree on, and let's all focus our energies in that direction.

RG: If you look back at 2015, ESG and SRI were very high on the political agenda. Many world leaders from Obama to Pope Francis have clearly focused their attention on sustainability, and the COP21 climate talks in Paris have generated even more awareness. I was very impressed with the level of activity among investors when it came to collaborative initiatives, such as the Montreal Carbon Pledge. In the space of just one year, 120 asset owners with over US$10 trillion in assets have agreed to disclose the carbon footprint of their investments. Candriam signed the Pledge and we are able to abide by it through our reports.

What is striking to me are some of the numbers involved: I'm sure you'll have seen the figures from the Global Sustainable Investment Alliance suggesting there's a global market for responsible investment of US$22 trillion versus a total of [assets under management of] US$77 trillion. In 2014 in the German-speaking countries alone, the market went from US$100 billion to US$200 billion – these are really big numbers. This growth is mostly institutional, but all international wealth managers have designed an SRI product offer, and this makes me very confident that SRI is about to become even more mainstream.

MM: The world is changing incredibly fast, and faster than many people realise. For example, Peabody Energy, the largest US coalmining company, has lost 99.5% of its value over the last four years. It's probably going to fall out of the main benchmarks this year.

There has been a huge change in how the investment industry is responding to the challenge of responsible investment. To give an example, a couple of years ago, when we were developing a low-carbon passive equities index, it was a bit of an uphill struggle. Now, I'm looking at introducing low-carbon into my smart beta portfolio, and, frankly, I'm struggling to keep up with all the people wanting to talk to me about the strategy, sending me product suggestions and showing me their research. Things are really starting to change on the supply-side – so, for the asset owners that have made commitments in this space, it's an ideal time for them to start implementing them.

2. AS THE INVESTMENT INDUSTRY'S SOPHISTICATION AROUND SRI INCREASES, IT OPENS THE DOOR TO A MORE MAINSTREAM AUDIENCE WHO MAY, IN THE PAST, HAVE SEEN THIS AS QUITE NICHE. BUT TO WHAT EXTENT IS SRI ADOPTION EXTENDING BEYOND THE TRADITIONAL LEADERS?

DG: We have seen much more mainstream interest in responsible investment, but, honestly, we haven't seen widespread incorporation yet, certainly not on the scale that we would like to see. There is a very big difference between making all the right noises around responsible investment and actually incorporating RI strategies into your organisation.

LH: The Pensions and Lifetime Savings Association carries out an annual stewardship survey, and every year we ask respondents whether they feel that ESG is material to their investment decisions: over the last couple of years, the percentage answering 'no' has fallen from 20% to a negligible number.

But that begs the question as to why SRI isn't more embedded. We asked those who hadn't signed up to the UK's Stewardship Code why not, and for most of them, they stated that other issues have taken priority. Pension funds face issues around longevity and how schemes are going to be funded sustainably in the medium term, major initiatives such as auto-enrolment, the freedom and choice reforms. For some, responsible investment is a less existential priority – that's particularly the case for smaller funds.

HF: At Redington, we are seeing a growing number of enquiries from our clients on SRI – there definitely is some momentum behind it. For us, the question is: how can we help our clients take action? Part of the answer lies, I think, in making the messages around SRI more simple. All of our clients have limited budgets, limited time, and they need to be experts in a huge range of subjects – what the industry needs are simple frameworks for decision-making around responsible investment. That requires the industry to think about the terms they use, and about standardising how asset managers report around SRI.

RG: I'd like to mention a couple of experiences I've witnessed, for example with the Italian and Dutch social investment forums, where they've brought together the industry – including pension funds, consultants, custodians etc. – to work together to consider what SRI is, how you can get involved, what kind of benchmarks you can use, what kind of engagement you can do. This is very useful – in the end, you get a toolkit, and investors can decide what they want to use.

LC: Pension funds will require a lot of guidance on how to proceed. It's one thing for the global leaders on responsible investment to absorb the flood of information that is coming out of COP21, and apply it to the implementation of

WE'VE SEEN MUCH MORE MAINSTREAM INTEREST IN RESPONSIBLE INVESTMENT, BUT WE HAVEN'T SEEN WIDESPREAD INCORPORATION YET

a climate change strategy. However, a lot of asset owners, especially small and resource-constrained ones lacking RI expertise, won't even be able to make sense of the influx of information coming in. They need appropriate guidance and support. There's a real opportunity here and we need investment consultants to grasp it. To do this, we will need to get past the 'clients don't ask, so we don't offer' mentality. This is about risk and opportunity identification – so we sometimes need consultants to be more proactive and map out for us ESG risks and opportunities that we haven't necessarily identified – as well as respond to the ones that we have.

LH: I think the way to do this is to make it clear that responsible investment is a key part of meeting other objectives, such as sustainably funding schemes over the long term.

3. SO WHAT HAS MOTIVATED THOSE AROUND THE TABLE TO IMPLEMENT SRI STRATEGIES – AND HOW MIGHT WE CONVINCE THOSE WHO HAVE YET TO TAKE THE PLUNGE?

MM: Certainly, the strongest driver for our approach to SRI is our desire to manage long-term risk – especially around climate change. There's also the 'universal owner' aspect. We invest across the entire market, so we want to help to raise standards – and returns – across the board. Managing our reputation is a more negative driver, but it is relevant sometimes. And we do see pressure from members – not on a day-to-day basis, but they want to know that the fund is on the right side, and they don't have to worry about it.

We also have a very supportive investment committee that is completely on board with our responsible investment programme, and they see it as a core part of their fiduciary duty. They've had lots of training on responsible investment over the years and have been provided with compelling evidence from the research we participate in and bring together. We're now at the point where we even have to hold them back occasionally – they're very keen we should continue to progress in this area.

JAnd: One of the Pensions Trust's investment beliefs is that responsible investment will enhance long-term portfolio returns, so for us it is primarily a financially-motivated decision. Our CIO has taken a leadership position on responsible investment, which is important. Implementing responsible investment often requires individuals to be quite innovative and to think outside the box.

In terms of implementation, it's also important to ensure responsible investment is embedded within the investment process and governance structures. Responsible investment can't just be a separate agenda item – it needs to be incorporated into how you make portfolio construction decisions.

HF: Our consultants are hearing from their clients that responsible investment is important, and they are keen to address it, but they are struggling because the guidance isn't clear enough. They may not necessarily want to be an industry leader, but they want to ensure they are doing enough. The issue for the SRI industry is how to give clear and simple guidance.

DG: That is exactly what the PRI has been working on and what we will be continuing to do: drawing up guidance on how to develop investment beliefs, how to develop investment strategies that are influenced both by investment beliefs and by fact-based systemic risks, and how to develop responsible investment policy as part of mainstream investment policy. PRI is well positioned to take on these challenges.

Jamb: There needs to be some conviction that you won't be worse off for pursuing responsible investment, and that you may be a little better off if you look at these factors. It's also helpful to have somebody to nudge you, such as a regulatory requirement – Ontario has recently introduced an ESG disclosure requirement, for example, and in France there are new requirements for investors to report their carbon footprint and their clean energy exposure.

Also, in the last couple of years we've seen a new 'citizen to investor' trend, things like ShareAction in the UK, which is trying to connect individuals with their pension funds. That's another driver.

The other fascinating thing is the role of investment consultants. In the last year or two, we've seen a lot of the other big consulting firms make progress in this area. If that continues, it will be incredibly helpful, because so many investment committees are really reliant on their consultants.

But when it comes to getting a fund over the line, it totally comes down to individuals: you've got to have enough people on the investment committee or the board to be willing to make the time to talk about it.

4. CERTAINLY WHAT MAKES INVESTORS SIT UP AND TAKE NOTICE IS THE PROSPECT OF INVESTMENT OUTPERFORMANCE. IS THERE ALPHA TO BE GENERATED FROM TAKING SUSTAINABILITY FACTORS INTO ACCOUNT?

RG: This is a longstanding debate, and it's the same debate as between active management and passive management. Is there sustainable alpha in SRI? There have been so many empirical studies – Harvard, Oxford University, the UN – and the reality is that SRI is not detrimental to returns, and in many cases it adds value. Sustainable alpha is very measurable. All

Sustainable Investing: **Because all the relevant information is not always in the balance sheet**

Candriam, conviction and responsibility

CANDRIAM INVESTORS GROUP
A NEW YORK LIFE COMPANY

IF YOU LOOK BACK AT 2015, ESG AND SRI WERE VERY HIGH ON THE POLITICAL AGENDA

of our portfolios and Candriam funds are benchmarked against traditional indexes, and we provide reports where one can see the breakdown of sustainable versus financial alpha. Looking at these numbers one can be impressed by how much sustainable alpha we add on strategies such as SRI emerging markets equity.

WVH: What the debate about ESG boils down to is values versus value. We've been taking ESG into account for a long time at Candriam, and our view is that it's not only about values – it's also about value creation through identifying hidden, intangible sources of risk and opportunity that you can't do through traditional methods. We believe that it adds value to the portfolio in terms of alpha, and that it mitigates risk. We have a very clear process, in terms of identifying best-in-class companies and applying norms-based and controversial issues screens, which allows us to align responsible investment practices with sustainable and financial alpha objectives.

MM: Whenever I'm asked if SRI adds value, I always say yes, but not easily or naively. Certainly, if you go back to the 1990s/early Noughties, a lot of SRI investors were very growth-orientated, with mixed results. A lot of the SRI aspects reinforced the biases inherent in growth investing, such as confirmation and optimism bias, and not to the best effect. In the last decade, however, there has been much more focus on quality – and quality and SRI investing has, generally, been a very happy marriage.

JAmb: The clearest examples of alpha generation, with the longest track records, tend to be in the fundamental active space. In thematic investing, for sustainability-themed managers, obviously sustainability is a core part of idea generation, and there are growing numbers of that type of manager with increasingly impressive track records – but a conviction about how the future won't mirror the past is also required in order to be interested in these themes.

On the corporate governance side, it's interesting to see developments in the passive space along the lines of universal ownership and engagement leading to better capital market performance.

WVH: What is crucial is that sustainable alpha isn't generated necessarily by applying, say, corporate governance across the board, or looking at climate change metrics – it varies by sector. It's about being able to identify which ESG factors are material and what will create value over the long term. For asset managers who are just beginning to look at this, it's a

challenge. Candriam's ESG research team looks at more than 200 ESG factors; to allocate the resources to properly integrate ESG, that's quite a hurdle.

Asset managers also need to look ahead. We manage money for an Australian client using a best-in-class approach, and they are thinking about what the next ESG issues might be – such as resource depletion, or the effects of demographic changes such as an ageing population. These are the sorts of things that aren't currently on the investment agenda, but will be. If you want to generate sustainable alpha, you need to think about these things now – because by the time they are on the agenda, the alpha will have already been generated.

5. SO, LET'S ASSUME THAT WE'VE NOW BOUGHT INTO THE CONCEPT THAT SUSTAINABILITY CAN GENERATE ALPHA: HOW DO YOU DISTINGUISH BETWEEN THOSE ASSET MANAGERS THAT SAY THEY DO SRI, AND THOSE THAT REALLY ARE?

JAnd: Asset owners should start by including questions about responsible investment in their RFPs, but it's really important to take the discussion right through the whole fund manager selection process – making sure that, during initial meetings or beauty parades, you're asking those questions of managers and seeking to understand how it fits into their investment process.

From our own experience, in terms of understanding whether a manager is really doing SRI, it comes through best in discussions with the portfolio manager – whether they can really talk through how it's relevant to the individual stocks or assets within the portfolio. That's the real proof of the pudding – if the portfolio manager, without the ESG analyst supporting him or her, can demonstrate that.

HF: We're asking questions of asset managers about their ESG capabilities as part of the RFP process – but just getting the answer back that "we've got six people in our ESG team" doesn't tell us that an asset manager is incorporating ESG into their investment process.

There are certainly some asset managers with really good responsible investment PR, who put out great thought leadership pieces, but for us to be persuaded that it's actually integrated into the investment process and the culture of the firm, you need to go in and ask a lot more questions.

When Redington's manager researchers go into a meeting with an asset manager, they want to understand the ESG or responsible investment philosophy of that manager, what motivates them to look at ESG issues, and they want the manager to explain how an ESG risk factor might flow from research into portfolio management, and into investment decision-making.

LC: There is an important industry-level discussion we need to have about the amount of signaling asset managers seem to need from asset owners that ESG is a major or even driving factor in awarding mandates. In the past, I have been told that this 'signal' is what is needed in order to get more internal ESG resource. If that is the case, what percentage weighting in the RFP should ESG be given in order for fund managers to give us a more meaningful understanding of ESG risks and opportunities in the mandate? What is the minimum weighting needed to move the dial? Is it 5%? 10%? The weighting will be dependent on the investment beliefs of the asset owners and may vary significantly.

Either way, we can't be stuck having the same conversations with fund managers where they say they don't have enough resource to give us the ESG information we need at a mandate level. That conversation needs to move on and, to be fair, I have seen early indications that it may well do so in the future – watch this space!

MM: This is an incredibly competitive industry – managers need to be aware that they can't afford to drop even 5% of the marks in an RFP. But we face a challenge in that we believe in integration, so we should integrate ESG across our manager assessment, rather than have a separate, big section on ESG. But that means we

THERE IS A VERY BIG DIFFERENCE BETWEEN MAKING ALL THE RIGHT NOISES AROUND RESPONSIBLE INVESTMENT AND ACTUALLY INCORPORATING RI STRATEGIES INTO YOUR ORGANISATION

THE ASSET OWNER SIDE OF THE INDUSTRY IS AT AN EARLY STAGE IN IMPLEMENTING RESPONSIBLE INVESTMENT, BUT ASSET MANAGERS ARE NOW MUCH MORE ENGAGED

only have a visible 5 or 10% score for the remaining aspects of ESG, such as industry participation and stewardship, although the actual importance of ESG is much higher.

There's an awful lot you can ask a manager: from broad, high-level philosophy down to portfolio construction, you can probe them about where they're bringing in ESG. The one most useful thing you can ask the actual fund manager is to provide some examples of where ESG has made a difference to the investment decision-making process, either positively or negatively. If the best example they can give you is Volkswagen or BP, they're not trying very hard.

LC: Asset owners also need to do a much better job of holding their fund managers to account. The first step in that regard is to get them to provide better reporting on the ESG risks and opportunities within the mandate in question, and how they are managing them. This may require a phased approach, with incremental improvements over time, but the dialogue on this topic needs to happen more often. A good resource for asset owners to use as a communication tool would be the *Guide to Responsible Investment Reporting in Public Equity*, which is available on the Pensions and Lifetime Savings Association website.

6. TO CONCLUDE, WHAT WILL – OR SHOULD – BE IMPORTANT THEMES FOR THE INDUSTRY TO ADDRESS IN 2016?

JAmb: I think regulators could play a potentially helpful role in 2016. The establishment by the Financial Stability Board of its taskforce to make climate disclosure recommendations to the G20 is incredibly important, and we're starting to see regulators get more interested in this space. If they take some significant steps, then boom! All our bottom-up work becomes a lot easier.

DG: A big question is how trustees can play a strategic role in incorporating ESG considerations into investment decisions. How do you get them interested?

HF: I would like to see the development of a clear framework for those who would like to get started with SRI.

WVH: One of the biggest advantages of the increased awareness around ESG is that everyone knows it's not about the short term – you can't materialise ESG alpha in the short term. Hopefully, this will help to push short-termism out of our industry.

LC: I would like to see the industry come up with a more formalised platform so that asset owners can more easily align their expectations of fund managers, and engage as a unit and target key managers that a lot of us are already invested with. This will allow us to really up our game as asset owners – I've seen evidence of how powerful it is when asset owners do collaborate in this area.

MM: Generally speaking, the asset owner side of the industry is at an early stage in implementing responsible investment, but asset managers are now much more engaged. This means that it is now easier than ever before for asset owners to embrace SRI. Specific areas that are important for 2016 are the continuing quantification of ESG data, enabling its use by systematic managers and smart beta, and the challenge of understanding the implications of a low oil price in a world that has been rapidly embracing low-carbon options.

INVESTING RESPONSIBLY WITH CANDRIAM
THE WAY TO GO

In today's cyclically swaying world economy, investment can be a risky business that SRI – a well-regulated source of longterm performance – can offset.

An investment process designed to select the best issuers from a financial and sustainable-development standpoint lets us control ESG and financial risk, and optimize investors' opportunities.

All investors are concerned about the environmental impact of their investments. As an investor, you attach great importance to the social responsibilities of companies in the management of their relationships with their employees, suppliers, customers and communities. You also value the principles of good corporate governance.

SRI ANSWERS YOUR CONCERNS

Sustainable and Responsible Investment (SRI) is an investment strategy that incorporates environmental, social and corporate governance (ESG) factors into the portfolio construction. Indeed, through ESG analysis, we identify additional factors that are not always apparent in traditional financial analysis even though they affect a company's long-term value and competitiveness.

NORMS-BASED ANALYSIS

Norms-based analysis determines whether a company is complying with the universal principles set forth in the United Nations Global Compact (UNGC). This additional analysis ensures selection only of companies that comply with the principal international standards.

CONTROVERSIAL ACTIVITIES CHECK

At Candriam, being responsible also means that we pay particular attention to companies involved in controversial businesses and activities such as Adult Content, Alcohol, Gambling, Tobacco, Weapons, and Activities in Oppressive Regimes. Companies that exceed acceptable levels of involvement in any of these activities will be excluded from the SRI universe of companies.

MACRO/MICRO SCREENING

Long-term sustainability trends can have a considerable influence on the global economic environment in which companies operate. The macro analysis gauges a company's exposure to the major sustainable development challenges.

Combined with micro analysis, which measure a company's ability to incorporate stakeholder interests into its long-term strategy, our in-house Best-in-Class screening assesses the sources of risks and opportunities for each company in a discrete manner.

1996	20%	35	9
Pioneer for **over 20 years**	Around **20%** of our total AUM in SRI(1)	dedicated SRI fund managers	SRI Analysts

(1) as at end-June 2015