Principles for Responsible Investment

GLOBAL DIVERSIFIED ALTERNATIVES
QIC

ENGAGING WITH AN AUTOMAKER ISSUER

SIGNATORY TYPE	**Investment manager**
OPERATING REGION	**Australia**
ASSETS UNDER MANAGEMENT (AUM)	**US$65bn***
FIXED INCOME AUM	**US$25bn***
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WHY ENGAGE WITH ISSUERS?

Following our own analysis of investment returns, and taking into account academic and peer studies, we believe that environmental, social and corporate governance (ESG) factors can have a material impact on the long-term returns of fixed interest investment portfolios. Consequently, relevant ESG factors feature in each step of QIC's five-step investment approach, are closely monitored by portfolio managers, and feed into security selection.

Direct engagement with debt issuers is integral to our responsible investment process as it allows us to understand and influence positive ESG practices to drive improved decision making and ultimately protect investment returns. It also allows us to fulfil our stewardship role.

* As at 30 September 2017

UNEP FINANCE INITIATIVE
United Nations Global Compact
An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

ENGAGEMENT PROCESS

Figure 1: Engagement: an integral part of QIC's five-step investment approach. Source: QIC

STEP 1: RESEARCH

We analyse an issuer's ESG practices as part of issuer due diligence. We also determine whether there are ESG-related mandate restrictions that would prevent investment. We contemplate external credit ratings and external ESG ratings and determine whether we agree with both sets of ratings, and whether there are industry or issuer-specific issues that warrant specific ESG engagement with the issuer. Engagement over credit concerns happens separately from ESG engagement: ESG engagement is a specific meeting with the issuer; credit engagement might be a formal meeting or could be a desktop review.

More information can be found in the following table

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STEP 2: SCORECARDS

Our scorecards and analysis templates ensure consistency across issuers, industries, and markets. Our credit analysis template includes a specific section on issuer ESG practices, along with other credit strengths and weaknesses, investment risks and financial analysis. Weak ESG practices will impact our overall view of a credit.

STEP 3: IDEA GENERATION

Our proprietary relative value tool incorporates ESG ratings together with a range of other security features such as credit rating, industry, deal size, currency and real-time pricing. This allows us to assess the value of a security using ESG ratings as one anchor. For example, if we are targeting an industry exposure, a credit rating, or a certain part of the curve, we can plot the securities that meet the criteria against each other and look for lines that have the widest spread for the highest ESG rating and vice versa. We can also easily identify positive screening switch trades - for example between issuers in the same industry with similar spreads but divergent ESG ratings. Similarly, we can identify securities where market pricing is not sufficiently differentiating risks.

STEP 4: INTEGRATING IDEAS INTO PORTFOLIOS

We value the trade ideas generated in step 3, target particular themes such as investing in companies with superior ESG practices versus their peers as evidenced by ESG ratings, or reducing exposure to companies that have not shown sufficient improvement in ESG practices, and incorporate them into portfolios.

STEP 5: ASSESSING PERFORMANCE OF OUR IDEAS

We can assess performance of ideas by specifically attributing and reporting performance of trade ideas, thus closing the feedback loop. For example, if we decided to short a high carbon emitter by buying protection through credit derivatives, we could attribute the trade as 'reducing carbon exposure' and track the performance of the strategy. Finally, we demonstrate transparency of our ESG strategies, positioning and framework through client reporting, ESG update reports, PRI reporting, and publishing ESG research papers.

Our engagement programme aims to engage with around ten issuers per year in one of three ways:

1. ISSUERS WITH ADVANCED ESG PRACTICES	2. ISSUERS WITH WEAKER ESG PRACTICES	3. THEMATIC ENGAGEMENT
We prioritise companies demonstrating advanced ESG practices so we can learn from them and encourage their peers.	We assess the range of ESG ratings within an industry, whether there are common (negative) themes or practices across the industry, the financial and non-financial (risk) materiality of those practices, and whether we are exposed to issuers whose practices are weaker than their peers.	We consider ESG issues that could impact financial returns. Generally, thematic issues will impact all issuers in an industry. We consider how advanced issuers are in their ESG practices so we can learn from the leaders and encourage the laggards.

ENGAGEMENT IN PRACTICE

ENGAGING WITH AN ASIAN AUTOMAKER ISSUER

The auto industry has been plagued in recent years with a range of ESG-related scandals, including emissions tampering, labour disputes, product recalls and accounting misstatements. Evolving regulatory requirements also mean the industry needs to adapt to meet stricter carbon standards. As a result, the industry met two of the three target areas of our ESG engagement programme: engaging issuers with weaker ESG practices, and thematic engagement.

We prioritised a large Asian-based auto manufacturer selling products globally under multiple brand names for engagement. We were an existing bondholder when we approached the company for an ESG engagement meeting. The auto manufacturer had an ESG rating of BB, at the lower end of its peers. Our proprietary relative value analysis had concluded that despite auto industry challenges, the market was not pricing ESG weaknesses in their bonds, as this issuer's bonds had similar spreads to other more highly ESG-rated automakers.

When we arrange an engagement meeting, we usually contact the company directly either through their investor relations team or through the CFO/treasury function. Occasionally, we will contact a bank syndicate to arrange an introduction, especially where we are not already a bondholder. We find the companies are usually receptive to meeting with us as they are keen to educate the market on their ESG progress and they generally acknowledge bondholders are an important provider of capital, despite not having shareholder voting rights. Being a large bondholder can carry weight but in some cases we have not been a bondholder but have engaged as a market participant. The latter tend to be 'thematic engagements' as well as focused on company-specific ESG practices.

At the intial engagement meeting, companies often send members of their investor relations team and responsible investment representatives. If our agenda is specific, the company will also invite relevant managers of divisions where ESG risks are prominent. In the case of the automaker, the company's key ESG risks were labour management, product safety and quality, and corporate governance. The company also faced a high level of risks related to carbon emissions regulations because of significant sales concentration in regions with strict emissions standards. Efforts in this area suggested this was already a priority for the company. It also had significant opportunities to benefit from increasing demand for clean tech applications, such as alternative powertrains. Of the ESG issues covered in the meeting, the company appeared most advanced in clean technology opportunities and carbon emissions reduction.

Figure 2: Discussion items for bondholder engagement meeting. Source: QIC

DISCUSSION ITEM	DISCUSSION OUTCOMES
Clean tech opportunities: fleet emission reduction targets and associated clean tech product development (e.g. bio fuel and hybrid vehicles)	Product carbon footprinting performance was a moderate risk and the company's risk management practices in this area were below our expectations.
Labour relations: sensitivities in labour / management relations and strategies to improve relationships	In comparison to peers, the company was bottom quartile in its management of labour disputes. However, the company was well-attuned to this issue and discussed putting measures in place to manage the risk.
Governance: structures to achieve optimal balance across key stakeholders	The company's governance profile ranked poorly because of its complex structure of cross shareholdings. The meeting revealed the company was aware of how this structure is viewed by investors and was considering what an appropriate structure may consist of. However, no further detail was available at the time.

FOLLOWING UP

We view engagement as an ongoing process, rather than a one-off tick-box exercise. To follow up, we scheduled a 12-month review to examine developments in all three areas. Three months after our engagement meeting, the company issued a new bond. Our credit analysis showed little change in the corporate practices we had identified as needing improvement. The company also had not advanced much further in meeting its ESG-related targets. As we believe it takes time for improvements to be realised, valuation of the security became key.

We did not feel that the pricing of the new bond adequately compensated investors for the current ESG risks and broader credit risk. When we analysed the spread offered on the new deal against other auto manufacturing bonds using our proprietary relative value tool, we determined the new deal was pricing in line with similar bonds from issuers that had higher ESG ratings. There was no additional spread offered (versus bonds of similar issuers) to recognise the weaker ESG rating or the issuer-specific risks. Spreads on this bond have also underperformed the domestic credit index.

As a result, although we remain a bondholder of other lines that mature shortly (before we anticipate meaningful progress on the company's ESG targets), we declined to participate in the primary market deal giving feedback to the syndicate and company that we had not seen sufficient progress on the matters raised in our engagement meeting to warrant further investment.

NEXT STEPS

We intend to continue with our formal ESG engagement programme targeting three key areas of learning from:

- issuers with advanced ESG practices;
- issuers with weaker ESG practices;
- thematic engagements.

In the next 12 months we are planning follow-up engagements with issuers, including the automaker, to assess their progress against the goals they shared during our initial meetings. Should we see meaningful progress in their practices and against their ESG targets, we may recommend increasing our exposure to their bonds.