PRI Principles for Responsible Investment

# ASSET OWNER MANAGER SELECTION GUIDE:

## ENHANCING RELATIONSHIPS AND INVESTMENT OUTCOMES WITH ESG INSIGHT

FINANCE UNEP INITIATIVE | United Nations Global Compact

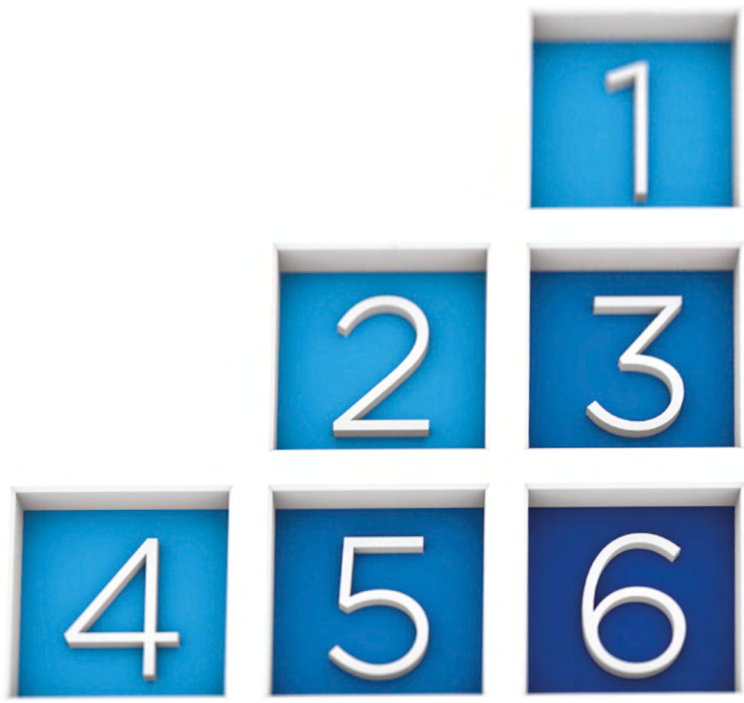
An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

# THE SIX PRINCIPLES

## PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.




## PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

# ACKNOWLEDGEMENTS

This guide incorporates the expertise of individual PRI signatories, without representing the views of specific asset owners. The PRI would like to thank the PRI Asset Owner Advisory Committee for its strategic advice, as well as contributors in the PRI Manager Selection Working Group, and the following individuals:

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# FOREWORDS

Selecting investment managers is more an art than a science. Try as we might to apply statistics and data comparisons, selecting one investment manager over another is ultimately a judgement call and hence more an art. This guide is intended to be just that: a guide, not a formula. It has been written for asset owners around the world, with every asset class in mind.

Investment performance is the goal, yet it does not provide a meaningful indication as to how a manager will perform in the future. We hear that past performance is not an indicator of future performance all the time. So, what is?

I propose the four Ps: People, philosophy, process and price. If you want an investment manager to think long term and incorporate environment, social and governance (ESG) factors, you need to ask them to demonstrate how they are doing this. This guide offers several starting questions, to be used in dialogue rather than as a rigid checklist. Talk is cheap and words are easy; it is an investment manager's actions and portfolio decisions that truly demonstrate whether they just know the letters E, S and G versus actually living ESG.

The four Ps combined epitomise the investment manager's overall culture. Understanding organisational DNA takes time and communication. This guide presents the opening questions, but it is down to individual asset owners to ask the deeper follow-up questions. This is not always easy; most of us in the investment business are more comfortable dealing with numbers than people and psychology – but ESG is a mindset.

Most asset owners have very long-term liabilities and must incorporate ESG risks and opportunities into their investment process. They must therefore employ investment managers that also have a long-term investment outlook. The challenge is identifying those managers.

**Christopher Ailman**
CIO, CalSTRS and Chair, the PRI Manager Selection Working Group

Asset owners, sitting atop the investment chain with long-term investment horizons, are ideally placed to drive responsible investment throughout the investment cycle. One of the most important ways to do this is by ensuring that the mandates they give to fund managers include requirements for analysing and reporting on ESG considerations.

The PRI is keenly aware of the role that asset owners can play in moving ESG incorporation into mainstream investing. But, as we have seen, too often asset owners fail to communicate these requirements to their managers, leading to a lack of clarity around ESG implementation.

To this end, the PRI has recently launched a series of guides, including the newly-released Asset owner strategy guide: How to craft an investment strategy, Investment policy: process & practice and A practical guide to active ownership in listed equity.

Our latest guide, *How to enhance manager relationships and investment outcomes with ESG insight*, shows that asset owners can positively influence the actions of other stakeholders across the investment chain, thereby helping to shape a more sustainable financial system.

Importantly, it does not provide a one-size-fits-all approach; rather, it focuses on the interactions between asset owners and investment managers, and examines how ESG considerations can be implemented during the manager selection process.

Ultimately, if asset owners want the financial markets to take responsible investing seriously, they must clearly convey their ESG commitments when they select, appoint, monitor and reward investment managers.

**Kris Douma**
Director, Investment Practices and Engagements, the PRI

# BACKGROUND

Efforts by the PRI to address ESG-related issues in the investment manager selection, appointment and monitoring process date back to 2013, with the launch of *Aligning expectations – guidance for asset owners* on incorporating ESG factors into manager selection, appointment and monitoring.

This guide – *Enhancing relationships and investment outcomes with ESG insight* – provides more detail on what ESG-related issues asset owners need to think about when looking to select an investment manager. It provides overarching guidance on incorporating ESG considerations across all asset classes, products and managers during the manager selection process. It is not intended to serve as a prescriptive manager selection process or due diligence guide and hence it does not follow a standardised selection process exhaustively. Instead, it focuses on areas where ESG issues are most prominent.

While being detailed, the guide is unable to acknowledge potential eventualities across all assets and investment situations. The sub-sections of each chapter offer a list of food-for-thought questions for asset owners to consider and ask prospective managers at the firm and/or product level. The PRI's definitions apply throughout, and can be viewed here.

**Figure 1: The PRI's work on asset owner processes: from strategy to monitoring**

1. INVESTMENT STRATEGY GUIDE
2. REVISE YOUR INVESTMENT POLICY
3. DESIGN YOUR ASSET ALLOCATION AND INVESTMENT MANDATE(S)
4. SELECT AN EXTERNAL INVESTMENT MANAGER
5. APPOINT EXTERNAL INVESTMENT MANAGER(S)
6. MONITOR EXTERNAL INVESTMENT MANAGER(S)

**Step one** is covered in the PRI's newly-released asset owner investment strategy guide, entitled Asset owner strategy guide: How to craft an investment strategy. Particularly useful for resource-constrained asset owners, it provides a step-by-step process for developing an investment strategy.

**Step two** is covered in Investment policy - process & practice: a guide for asset owners, which focuses on how to codify strategies into effective investment policies.

**Step three** helps asset owners understand their mandates by reverse engineering relevant aspects of desirable manager selection outcomes. The PRI will work on the topic of asset allocation and the Sustainable Development Goals in 2018. Further details on mandate design can be found from the International Corporate Governance Network – Mandate Design Initiative.

**Step four**, covered in this guide, focuses on how asset owners can enhance their manager relationships and investment outcomes with ESG insight.

The PRI will release further asset owner guidance later in Q2 2018, on appointing (**step five**) and monitoring (**step six**) investment managers.

# EXECUTIVE SUMMARY

## INVESTMENT APPROACH

Culture is one of, if not the, most important element to consider when selecting an external manager. If there is no cultural fit and understanding of ESG factors between an asset owner and a potential manager, there is little fundament to establish a long-term investment relationship.

Questions on investment approach and objectives should shed light on how a manager produces value through ESG insight. Understanding the business and investment philosophy of a prospective manager enables asset owners to ascertain whether such an approach is in line with their own objectives.

An investment policy should reflect an asset owner's strategy and views on best practice in managing investments, including incorporating ESG factors. A written investment policy should define what ESG means to an investment manager in practical terms. While strong cultures may override weak policies, it is vital that policies are recorded and endorsed by the board and CEO. An assessment of the policy should indicate whether it is compatible with an asset owner's ESG-related definitions and expectations.

An investment manager may not have the same level of ESG competency across all asset classes. Manager firm-level practices may also not be fully suitable for all asset classes due to style, culture or resources. When selecting an investment manager, asset owners should first look at the firm's overall ESG alignment, then its capability in a specific asset class, and then choose a suitable investment product.

A firm's approach to investment governance will depend on its culture, style and size. Certain investment approaches may also require a specific set-up of resources that needs to be observed. An evaluation of a manager's resources should also extend to the quality and suitability of its external vendors as a regular part of operational due diligence.

## PORTFOLIO CONSTRUCTION AND INVESTMENT DECISION MAKING

Services that provide product-level information on portfolio holdings exist, and as part of their reporting to the PRI investment managers answer questions on ESG incorporation processes at the firm level. However, true understanding can only be gained from well-executed dialogue.

Investment managers must ensure that investment processes incorporate ESG analysis, and that such insight is presented to investment decision makers (and that those decision makers are able and empowered to act accordingly). Asset owners should verify that final decision makers use available ESG material and organisational insight in their investment decisions. They should also ask prospective managers to support any claims with evidence and real examples.

Investments always have real economy impacts that can be positive and/or negative (for example, they may increase or decrease pollution levels, generate corporate and income taxes, support employment or create discrimination) and are intertwined with long-term prosperity. Asset owners that limit analysis to purely risk and return are missing a crucial element in their portfolio's contribution to end beneficiaries and society at large. Clarity on real economy impact expectations during the selection phase will help to align interests for a productive long-term commercial relationship. Asset owners must also be clear about what risk means to them at each level of the investment process, and how it can vary across the portfolio.

In portfolio construction, it is not just a question of what goes in, but how much goes in. Parameters like tracking error are important as they directly influence choice of investments, but may not be critical.

Thematic and screening approaches select investments in securities that fit into certain criteria and play increasingly important roles in asset allocation considerations. Asset owners should pay close attention to the methodology, rules and accuracy of chosen screens during the selection process.

One way to ascertain the effectiveness of an investment manager's integration approach is to consider the price of an investment firstly with and then without ESG factors accounted for. Activities portrayed as "integration" often merely amount to simple screening, whereas integration done well is a powerful method of fundamental analysis.

Asset owners that wish to include impact investments in their portfolios should seek to understand how their managers define impact and how they seek to measure such impact. One problem facing the industry is the branding of certain funds as impact investments without a clear link to end results. It is therefore vital that asset owners help to maintain the integrity of the market by choosing products and funds that genuinely deliver positive impacts.

## ENGAGEMENT AND VOTING

It is often the case that a single asset owner or manager represents a very small part of a company's overall capital. A group of investors of the same standing will therefore tend to have a stronger chance of engaging successfully than one single voice. Collaborating with peers also facilitates the dissemination of best practices across the industry.

The process an investment manager uses to engage, as well as its perceptions of engagement, should always be assessed. It is also important to understand the semantics around engagement and voting practices, as some managers may promote pure voting activities as engagement. Engagement activities can directly impact financial performance.

Asset owners should ask for examples of how a manager's engagement approach is structured. Identifying the individuals responsible and understanding the related processes is a good first step, with ascertaining how those individuals interact with investment decision makers a good second step.

It is also important to find out whether engagements are initiated across all of the manager's assets. If the manager outsources engagement to a third party, asset owners should assess the terms of the arrangement and the sustainability of the relationship. Asset owners should have the same fundamental perspective on engagement regardless of whether an active or passive strategy is in question.

When engaging through service providers, asset owners should ideally define topics to raise, as well as companies to target and objectives to achieve (this may be done via a policy or as a more hands-on, one-off exercise). Asset owners should participate in the engagements they care most about and establish during the selection and appointment process how such arrangements will work.

During the selection process, asset owners should understand the voting process and assess the quality and suitability of the execution of these processes, as well as any professional parties involved. From a selection perspective, asset owners need to make sure the mechanistic aspects of the voting chain function properly, that quality service providers are obtained and that votes reflect their target(s).

Some investment managers lend equity and bonds to boost their portfolio returns. If those securities are not recalled in time to exercise voting, the borrower is entitled to vote them. Negative publicity might cause controversial votes in stocks with concentrated ownership. Similarly, selecting a product that provides synthetic exposure to a stock or an index through a derivative might not come with voting rights.

## REPORTING

The selection process should consider the ongoing reporting from the manager to the asset owner and satisfy the latter's internal investment-related information requirements, as well as be able to serve their own reporting to stakeholders.

# GAINING A HIGH-LEVEL VIEW OF PROSPECTIVE MANAGEMENT FIRMS

There are important distinctions between a manager's firm-wide investment process or approach and how a product is governed. An asset owner may identify desirable firm-level ESG practices that are aligned with its investment strategy and policy, but if it selects a product where ESG factors are ignored or not aligned with broader aims and objectives, the ESG and investment impact will be limited, nulled or negative. On the other hand, if selecting what appears to be a well suited ESG product or ESG integrated mainstream fund from a manager that lacks a high-level strategic policy and cultural commitment to incorporating such factors, an asset owner would need to question if that product has the long-term institutional support to survive. Asset owners also need to be wary of potential future style drift of a chosen product.

This chapter focuses on an investment manager's culture, investment approach and objectives, investment policy, time horizon, asset classes and governance. Looking at these areas gives asset owners a high-level understanding of prospective management firms as well as product insight. Asset owners should also ask for examples of successful and non-successful ESG integration to gain a fuller understanding of what success looks like (or should look like).

## CULTURE

Culture is one of, if not *the*, most important element to consider when selecting an external manager. In this context, culture represents a set of habits, codes and expectations that govern how an organisation invests, regardless of its size and geographical location. If there is no cultural fit and understanding of ESG factors between an asset owner and a potential manager, there is little fundament to establish a long-term investment relationship.

However, culture is an ambiguous concept. Questions about manager ownership and management alignment with the incentive structures, beliefs and values of decision makers – beyond their technical competencies – are key components to assess. For example, it is important to find out whether a firm's culture is distribution led, with incentives related to asset accumulation, or investment led, with incentives reflecting investment outcomes. Assessments should reveal how "cultural outcomes in firms [need to] embody respect for public interest objectives", as cited by the FCA's CEO, Andrew Bailey, at the HKMA Annual Conference for Independent Non-Executive Directors in March 2017. We recommend that all selection processes culminate in on-site meetings, with asset owners meeting the prospective manager's team to gauge cultural fit. Regardless of whether a consultant is used in the selection process or an asset owner works independently, culture must be addressed in all Requests for Proposals (RfPs).

**Questions to explore firm culture**

- What is your overall investment philosophy, including how you believe incorporating ESG factors adds value? How is this embedded throughout the organisation?
- What is your investment style and philosophy and how are these incorporated into your strategy?
- Please describe how your organisation incentivises staff. Is ESG insight considered?
- Are you a long-term manager that is able to perform within the chosen investment time frame?

## INVESTMENT APPROACH AND OBJECTIVES

Questions on investment approach and objectives should shed light on how a manager produces value through ESG insight. Understanding the business and investment philosophy of a prospective manager enables asset owners to ascertain whether such an approach is in line with their own objectives.

Investment objectives usually differ across managers, strategies, funds and products. Asset owners will encounter high-level statements and more specific objectives closer to the product level during the selection process. The most straightforward approach would entail ESG incorporation being part of a management firm's overall investment objectives and reflected across all activities and products. This might include a mission statement, an outline of thematic investment strategies and active ownership objectives, and an ESG benchmark for a manager's operations.

The selection process is more complex when ESG factors are not explicitly expressed in investment objectives. It is possible, although rare, that a management firm that does not express ESG commitments in high-level objective or approach statements still uses ESG insight in investment decisions. To avoid greenwashing, however, asset owners should ascertain how high-level approach and objectives statements that include ESG considerations are operationalised across the firm and employees.

If an asset owner's investment strategy does not align with a manager's firm-level objectives, the asset owner must reconsider whether to grant a mandate. As previously discussed, assessing investment approach and cultural fit is crucial and can be reinforced by reviewing policies (more on policy below). For example, a fund that measures its carbon footprint without aiming to mitigate portfolio risk in a +2 degrees scenario might be unsatisfactory for an asset owner that strives to have a positive real economy influence in line with associated targets.

**Questions to explore investment approach and objectives at the firm level**

- **When preparing for the manager selection process, reflect on:**
  - How your strategy and policies constitute an approach that considers ESG factors.
  - How you plan to align a manager's investment approach with your strategy and policy, and what alignment means to you.
- Please outline how your investment approach is informed by global trends, including those related to sustainability.
- Please describe how and to what extent ESG risks and opportunities are incorporated into your approach.
- What would you say are your competitive ESG strengths relative to your peers?
- How do you operationalise a broad fiduciary duty concept (cognisant of ESG factors) in your investments?
- What are your objectives for ESG incorporation in your investment approach?
- How do you ensure that ESG issues are embedded and systematically feed into all investment decisions?
- How do you review and update your investment approach? How do you monitor the relevance of your approach in a changing investment environment?
- Do you use an ESG index benchmark or a standard benchmark with added ESG requirements?

**Questions to explore investment approach and objectives at the product level**

- How will you ensure that the product aligns with top-level firm approaches?
- Are all firm-wide objectives and approaches applicable to this product? If not, please explain why.

## INVESTMENT POLICY: CODIFYING A STRATEGY

Asset owners should implement their investment policies and develop risk management, asset allocation and mandates accordingly. An investment policy should reflect an asset owner's strategy and views on best practice in managing investments, including incorporating ESG factors. See the PRI's Investment policy: process & practice report for further guidance.

It is important to establish whether a manager's firm-wide investment policy reflects internal stakeholder consensus. However, it is not uncommon for a management firm to have more than one investment policy; a multi-asset, multi-approach firm may be unable to formulate a single policy that can serve its entire client, asset and product base. For multi-asset offerings, more detailed policies are often found at the strategy, business line and product levels. Policies and term sheets, fact sheets, fund operational documentation, risk management frameworks and marketing materials often overlap. At a specialist, more narrowly-focused manager, policies are likely to be expressed at the firm level.

A written investment policy should define what ESG means to an investment manager in practical terms. While strong cultures may override weak policies, it is vital that policies are recorded and endorsed by the board and CEO. An assessment of the policy should indicate whether it is compatible with an asset owner's ESG-related definitions and expectations.

Any conflicts detected may be significant and result in selecting a different investment manager, or establishing terms during the appointment phase (for an example in private equity, see the PRI's Incorporating responsible investment requirements into private equity fund terms guide).

Asset owners should compare the policies of prospective managers, which is not always an easy task as they must assess how managers address ESG factors as well as how policies are adhered to. Policies that marginalise ESG considerations, or institutions that have separate ESG policies, may compromise the depth of delivery across the firm on related objectives. However, a firm with a strong culture of long-term independent and analytical thinking might be a better fit than a firm with a well formulated policy, but no relevant cultural commitment.

### Questions to explore codifying policy strategy at the firm level

- Do you have a firm-wide investment policy that incorporates ESG considerations, or a separate ESG or responsible investment policy?
- If the policy's ESG elements are not firm-wide, which parts of the firm do they cover?
- Which policy definitions do you use for ESG factors across the firm?
- How often is your policy reviewed and has your approach to tackling ESG issues evolved over time?

### Questions to explore codifying policy strategy at the product level

- If you have a product or asset class policy, does it align with the organisation-level policy and/or have a clear link to your firm's investment approach and objectives?
- How might ESG incorporation regarding this product change due to evolving (responsible) investment policies?

## INVESTMENT TIME HORIZON

An asset owner's ESG-related objectives should translate into investment decisions with appropriate long-term time horizons. For example, it can be difficult to achieve positive real world impact and reap competitive returns with a high-turnover, short-term product as ESG factors tend to play out over a long period of time. This also holds true culturally; for example, short-termism can manifest in unnecessarily heavy trading patterns reflecting a firm's management style.

While short-term metrics may be relevant at times, short-termism is neither desirable nor conducive to responsible investment. High churn is likely to complicate active ownership and make any positive real world impact or ESG risk reduction difficult to monitor. Asset owners must be aware of this when selecting managers. For more information, see the PRI's How asset owners can drive responsible investment - Beliefs, strategies & mandates paper.

Investment process rigor and product integrity can ultimately only be explored post-fact and by the asset allocation decision itself. It is also important to remember that cultural fit may not guarantee long-termism; asset owners must remain critical of themselves and how they conduct manager research.

### Questions to explore investment time horizon at the firm level

- Do your internal incentive structures encourage long-term investment?
- Please describe how long-termism has informed your investment strategy, approach, policies and processes.
- How has your organisation resisted short-term pressures?
- Please give examples of how you promote the long-term success of the companies you invest in.
- How do you foster a culture of long-term investment decision making at your firm?
- Are your ESG objectives clearly defined and within the appropriate time frame?
- Are you aware of, and aligned with, our investment time frame?

### Questions to explore investment time horizon at the product level

- How do your ESG objectives match the investment time horizon of this product?
- Please give examples of how you have promoted the long-term success of the companies in this portfolio.
- Please outline how portfolio manager and investment staff remuneration reflects the long-term value creation mandate of this product.
- How does the portfolio construction process resist short-term pressures?

## ASSET CLASSES

An investment manager may not have the same level of ESG competency across all asset classes. Managers' firm-level practices may also not be fully suitable for all asset classes due to style, culture or resources. Asset owners should therefore ascertain how managers use ESG insight across asset classes. The extent to which ESG principles are embedded across the organisation may highlight cultural and/or staff competency deficiencies in less established asset classes. When selecting an investment manager, asset owners should first look at the firm's overall ESG alignment, then its capability in a specific asset class, and then a choose a suitable investment product. ESG capabilities related to specific asset classes within a mandate must be evaluated.

The PRI's asset class-specific guides is outlined below.

**The PRI has issued several asset class guides in recent years, including:**

## PUBLIC MARKETS

**Listed equity**

- A practical guide to ESG integration for equity investing

**Debt**

- Fixed income investor guide
- Corporate bonds: spotlight on ESG risks
- Sovereign bonds: spotlight on ESG risks
- Shifting perceptions: ESG, credit risk and ratings – part 1: the state of play
- ESG Engagement for Fixed Income Investors - Managing Risks, Enhancing Returns (webinar)
- Climate Strategies for Sovereign Bond Investors (webinar)
- ESG Analysis for Energy and Utilities Credit Analysts (webinar)

## ALTERNATIVE INVESTMENTS

**Hedge funds**

- Due Diligence Questionnaire for Hedge Funds
- Responsible investment and hedge funds

**Private equity**

- Private equity LPs' responsible investment due diligence questionnaire
- Responsible investment in private equity: a guide for limited partners
- Incorporating responsible investment requirements into private equity fund terms
- Workshop on human rights in private equity: summary and discussion
- IIGCC-PRI guide on climate change for private equity investors

**E&S**

- Impact Investing Market Map

## REAL ASSETS

- Managing ESG risk in the supply chains of private companies and assets
- Responsible investment in infrastructure
- Sustainable real estate investment: Implementing the Paris climate agreement – an action framework

### Questions to explore asset classes at the firm level

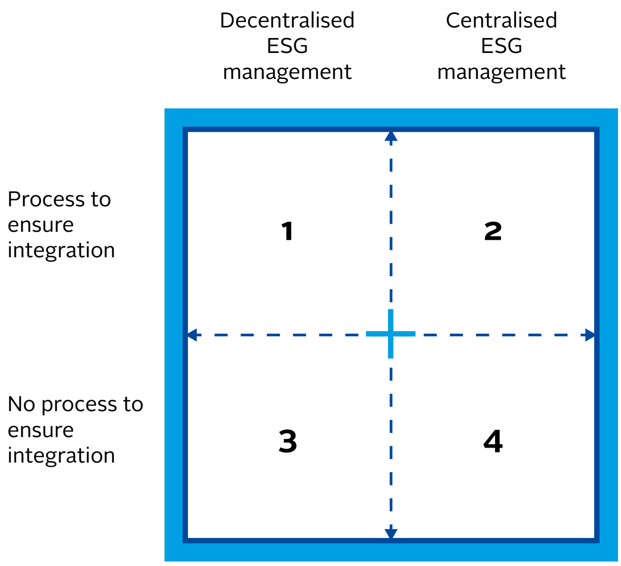
- Which asset classes does your ESG framework or policy cover?
- Does your investment approach, ESG staffing and philosophy vary among asset classes?
- How has ESG incorporation evolved at your firm? Which asset classes did you cover first?
- How do you incorporate ESG issues in the asset class we target?
- What is the depth of ESG product offering in the asset class we are interested in? How does that compare to other asset classes?

## GOVERNANCE AND ORGANISATIONAL ARCHITECTURE

A firm's approach to investment governance will depend on its culture, style and size. Certain investment approaches may also require a specific set-up of resources that needs to be observed. For example, with quantitative and screen-driven investments, the ESG function might be outsourced. Sound governance ensures that a firm's investment approach is embedded throughout the organisation.

As the figure below shows, a dedicated ESG team (i.e. centralised structure) can be responsible for day-to-day ESG incorporation.

**Figure 2: Matrix analysis of the management dimension. Source: Sustainalytics, IRRCi**



Alternatively, all investment team members might contribute to ESG insight and incorporate ESG factors into decision making – also known as the integrated model or decentralised structure. Meanwhile, many firms have adopted hybrid solutions combining elements of both. Governance transparency and quality of the chosen structure is crucial and it is not possible to rank one above the other (centralised versus decentralised) as a guarantee of robust ESG incorporation. According to research by the Investor Responsibility Research Center Institute (IRRCi), the management dimension of ESG incorporation is fundamental to integration[1], ultimately determining its quality. Strong policies safeguard ESG incorporation integrity regardless of organisational architecture.

Further information on organisational design choices in ESG integration can be found in the PRI's A practical guide to ESG integration for equity investing report.

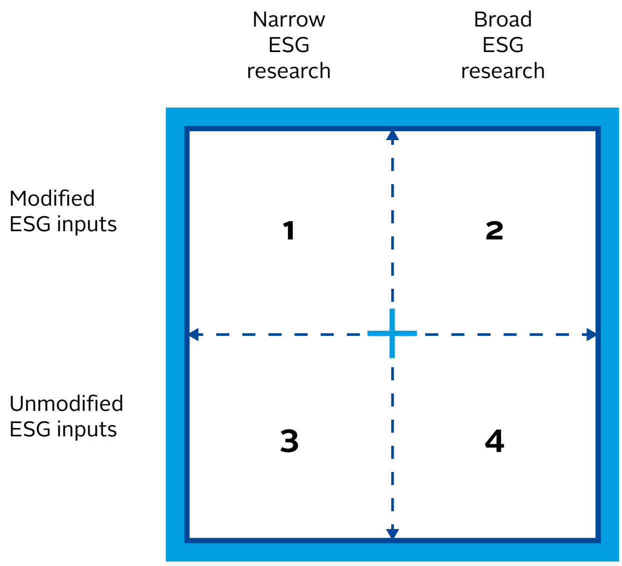
Asset owners need to understand how investment managers add ESG value across all their activities, and whether there is a reasonable expectation that the governance process is conducive to the owner's ESG objectives. For example, if the compliance, sales or marketing team oversees ESG-related matters, individuals in the team must have the requisite competency and authority to incorporate and analyse ESG factors.

Investment managers may also partly or fully outsource their ESG activities using ESG indices, ratings, consultants and engagement service providers in different stages of the investment process. Therefore, evaluating a manager's resources should extend to the quality and suitability of its external vendors as a regular part of operational due diligence.

If a manager outsources a component of its ESG understanding to an external partner, it is important to verify whether that manager is able to modify, monitor and control those inputs.

WARNING: Unmodified and superficial external ESG inputs may not positively contribute to the product in question if implemented under a culture that does not appreciate the value of ESG insight more generally. Please see more detail in the IRRCi's How Investors Integrate ESG: A Typology of Approaches.

**Figure 3: Matrix analysis of the research dimension. Source: Sustainalytics, IRRCi**




The stability of external relationships is also an issue for asset owners looking for a long-term relationship. As firm-level ESG resourcing decisions are likely to filter down from the organisational level to the product level heterogeneously, it is important to discuss preferred approaches at the most appropriate level.

### Questions to explore governance at the product level

- Who is responsible for incorporating ESG factors? What measures are in place to safeguard the long-term stability of that structure and relationship? Can we meet the team members?
- How will you ensure that there are no conflicts of interest regarding this product?

1 Please note that the IRRCi's use of the term integration also includes passive management strategies and is typically expressed as ESG incorporation in PRI documents.

### Questions to explore governance and organisational architecture at the firm level

- Please describe your organisational governance structure, roles and responsibilities when it comes to ESG incorporation. Who oversees ESG implementation?
- What governance structures are in place to address conflicts of interests between clients, or between managers and clients?
- What reporting systems and tools are used to provide the required information for effective oversight?
- Do you have a dedicated ESG team? If so, please describe:
  - the relationship between ESG specialists, analysts and portfolio managers;
  - the culture and balance of power between ESG teams and other teams;
  - where the ESG team is physically located relative to portfolio managers; and
  - how your risk team has been trained to deal with and monitor ESG issues.
- If there is no ESG team, have mainstream analysts and portfolio managers been trained on ESG issues and what ESG research do they conduct? Has your risk team been trained to deal with and monitor ESG issues?
- What led to your decision to hire an ESG specialist team, or what led to you decision not to hire ESG specialists?

# PORTFOLIO CONSTRUCTION AND INVESTMENT DECISION MAKING

This chapter focuses on ESG in investment decision making and portfolio construction, as well as on the risk and return framework. Questions on how investment decisions are made, how information is interpreted and what information is available are considered. How a manager perceives risk and return, and how that view can be used to invest with an ESG mindset, will also be discussed, along with screening and integration processes.

Questionnaires can be a useful information-gathering tool for many of the themes discussed in this chapter. Few questions require examples, but the majority are well suited for a RfP/DDQ-type of document. However, while mechanistic investment processes can be covered in questionnaires, a thorough assessment of ESG in portfolio construction and decision making requires direct interaction between an owner and a manager.

One issue that asset owners often face is when a manager's public report covers institutional aspects, with limited product-level information. Services that provide product-level information on portfolio holdings exist, and as part of their reporting to the PRI investment managers answer questions on ESG incorporation processes at the firm level. However, true understanding can only be gained from well-executed dialogue.

## INVESTMENT DECISION MAKING

An investment manager's decision-making process must facilitate the realisation of an asset owner's ESG imperative. Investment managers must ensure that investment processes incorporate ESG analysis, and that such insight is presented to investment decision makers (and that those decision makers are able and empowered to act accordingly).

For example:

- With active management and investment committees, either a designated and informed member brings ESG considerations to the attention of the committee, or all members are informed and targeting or actively considering ESG factors when they make investment decisions.
- With a quant process, the algorithm would be designed to embed ESG insight and use ESG data as input.

History shows that ESG incorporation is likely to be less present in investment processes than is often anticipated at a first glance of policies and process descriptions in marketing literature. For example, in fixed income, the PRI found in its recent work on credit ratings: "It (ESG consideration) can be advisory in nature and the responsibility often falls on ESG analysts alone to raise 'red flags'. Hence, at this stage, full ESG integration appears some way off." These observations are also supported by recent IRRCi/Sustainalytics research on ESG integration.

### APPROACHES TO ESG IN INVESTMENT DECISION MAKING

**Descriptive**

Descriptive ESG generally means rules-based, as opposed to normative ESG or principles-based (discussed below). Descriptive ESG works well for some asset owners due to its simplicity and ease of execution. These types of measures and structures are relatively easy to assess when selecting an investment manager. They are also easier to implement in the appointment phase and to monitor and report on. Nevertheless, it is important for asset owners to understand the impact and limitations of such measures. For instance, if a company is on an exclusion list, does that mean it should be disinvested from all portfolios? And, if so, in what time frame? Further considerations on how assets are subsequently allocated, such as in the index, or only within the sector from which the company was removed, must be considered. When a descriptive measure is used, asset owners should prescribe a list of rules.

**Questions:**

- Do you have an ESG exclusion or inclusion list, and what governs these exclusions? Do you remove companies from the portfolio for non-compliance with the ESG policy?
- Do you blacklist countries and issuers, and which issues do these relate to (e.g. corruption, corporate governance, etc.)?

**Normative**

Normative ESG generally means principles-based, as opposed to being descriptive or rules-based. In cases where ESG incorporation requires a higher degree of judgement by the investment manager, measuring compliance against an asset owner's ambitions and objectives is more complex. Asset owners must understand if there are tangible metrics to evaluate ESG compliance, and work on creating them if they do not exist. For example, if a product needs to be managed with the objective to remain within a +2 degrees scenario, an investment manager would need to demonstrate how this is being adhered to. This is a complex process for which a descriptive approach would be inappropriate. Elaborating on the process and using measures of judgement and best practices would be a more effective approach.

**Questions:**

- Please describe how you merge financial and ESG criteria during investment analysis.
- How often do you review the ESG risk exposure of the portfolio and how often have you changed the investible universe based on those findings?

Asset owners should verify that final decision makers use available ESG materials and organisational insight in their investment decisions. They should also ask prospective managers to support any claims with evidence and real examples to avoid “integration-washing”.

**Questions to explore investment decision making at the firm level**

- How does ESG incorporation affect your investment decision making when it comes to investment valuations?
- What challenges have you encountered during the investment decision-making process, and do you foresee any others related to your approach to ESG incorporation?
- Please describe your firm’s investment decision-making process: is there a single decision-maker, a group process or a quant? Or do you take a different approach?
- Please discuss the background and competency of investment decision makers at your firm when it comes to ESG incorporation.
- To what extent are portfolio managers involved in active ownership activities and able to use insight acquired?

**Questions to explore investment decision making at the product level**

- Please give five examples of how ESG issues have influenced investment decision making.
- How do you foresee ESG issues influencing investment decisions?
- What challenges do you anticipate in your ESG integration approach?
- How do you interpret our ESG or responsible investment objectives, and how would you execute investments that are aligned with our beneficiary demands?
- What ESG data, research, resources, tools and practices will be used to incorporate ESG factors into the investment processes, valuations and other investment decisions you make for this product?
- What are the main ESG factors affecting the portfolio and why is this the case?
- How will you ensure that all material ESG data available at the firm-level will be used to benefit this product?

The PRI recently published a guide that discusses ESG integration in public equity portfolios. The guide provides further considerations and case studies for asset owners when it comes to understanding ESG factors in investment decision making.

## RISK-RETURN FRAMEWORK

### RISK

There are myriad views on and definitions of risk. For example, an asset owner may perceive risk as the likelihood that a result does not align with its long-term investment goals or as surplus risk. For a long-only investment manager, risk is usually associated with deviation in return versus a benchmark. For an absolute return fund manager, risk is often defined as not meeting a fixed return target.

Asset owners must be clear about what risk means to them at each level of the investment process, and how it can vary across their portfolio. This is particularly important as measures of risk linked and monitored in manager relationships for investments within a portfolio may not always reflect an asset owner’s long-term goals and overall plan perspective.

An asset owner’s ESG or strategic risk framework needs to be embedded in mandates and followed through in the selection process. One cannot expect that buying into a mutual fund tracking the S&P 500 Index without exclusions or tilts will comply with an investment policy or strategy that states: “We see carbon exposure as the biggest investment risk to our long-term performance”. Likewise, reputational ESG risks such as potential labour and environmental controversies in an investment portfolio should be identified in an asset owner’s investment policy (and averted).

With expanding understanding of risk premia and sophisticated portfolio risk analysis, asset owners are more able to uncover ESG relationships with all traditional risk measures. The selection process should test a manager’s ability to supply relevant analysis.

## Questions to explore risk framework at the firm and product level

- What issues can materially impact your investment performance and why? Which risks do you monitor through your firm's research?
- How do you monitor long and short-term risks and their investment relevance? Is your risk function trained and resourced adequately to identify ESG-related risks?
- What are the major ESG risks you identified in individual holdings and what are you doing to mitigate them? Can your investment teams access thematic ESG risk research?
- How would you respond if you identified an investment with significant ESG risks?
- How do your views on minimising reputational risks align with our views and product policies and terms?
- How will you mitigate ESG risks in holdings? How does the product benefit from firm-level risk research?
- How will you minimise or eradicate reputational risk?

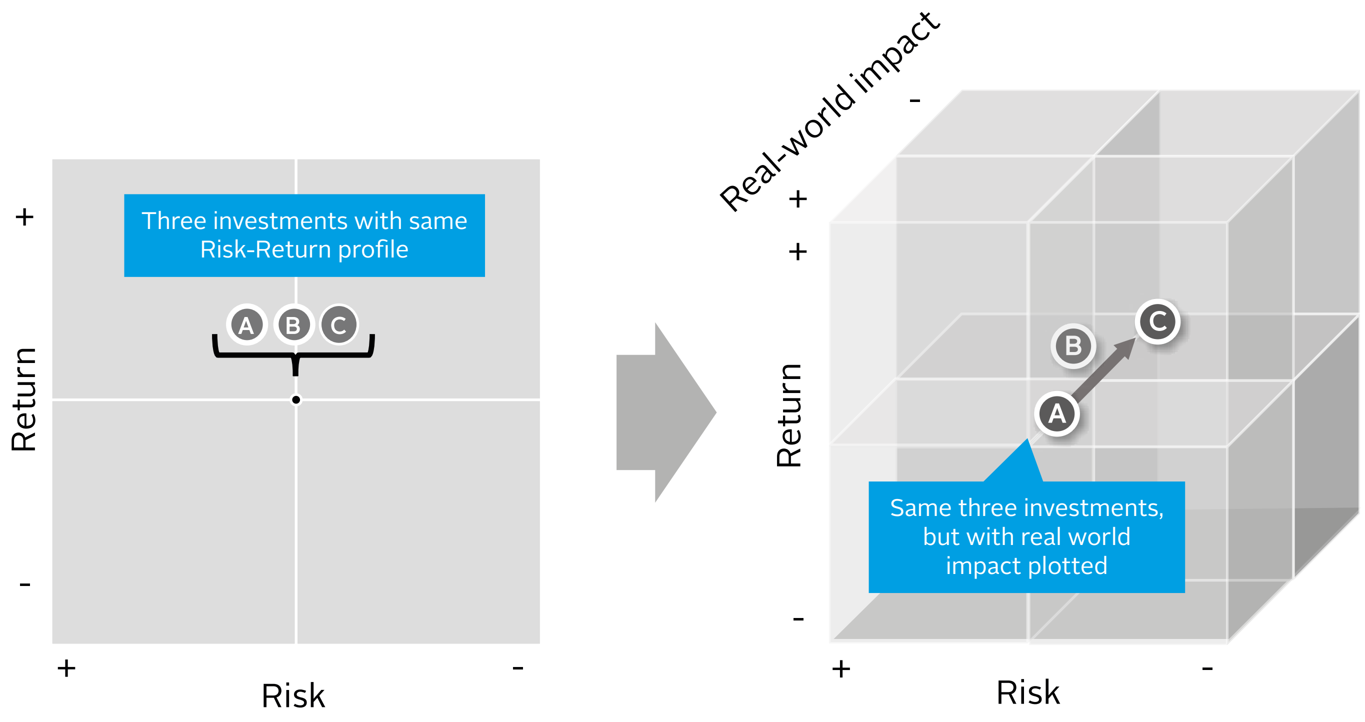
## RETURN

Returns alone and ESG outcomes specifically are treated and targeted in different ways by asset owners and investment managers. This may be due to differing commercial strategies, investment competency, legal, fiscal and tax systems, and may also reflect alternative perceptions of fiduciary duty.

The PRI's Asset owner strategy guide: How to craft an investment strategy guide encourages asset owners to explore their views on megatrends influencing the future investment environment and real economy impacts to determine how their institution can best generate returns (see here for a recent report on megatrends). As the diagram below demonstrates, for some market participants, investments only have financial risk and return aspects, while for others a third dimension – real world impact – is also contemplated.

Investments always have several real world impacts that can be positive and/or negative (for example, they may increase or decrease pollution levels, generate corporate and income taxes, support employment, create discrimination or be inclusive, etc.) and are intertwined with long term prosperity. Asset owners and the investment chain more generally that limit analysis to the two main dimensions covered in the diagram below (risk and return) are missing a crucial

**Figure 4: Real world impact as a third dimension to risk/return considerations.**



element in their portfolio's contribution to end beneficiaries and society as a whole.

Ideally, a manager will deliver positive real world impact that is aligned with an asset owner's needs as an integrated aspect of their risk and return considerations. Clarity on real economy expectations during the selection phase will help to align interests for a productive long-term commercial relationship.

### Questions to explore return framework at the firm and product level

- How do you monetise future financial returns by participating in megatrends?
- How do you integrate externalities into your investment return framework?
- Are ESG factors assessed as part of the financial return or separately?
- How will the ESG performance of investments impact your financial models and company valuations?

## PORTFOLIO CONSTRUCTION

In portfolio construction, it is not just a question of what goes in, but how much goes in. Parameters like tracking error are important as they directly influence choice of investments, but may not be critical.

Portfolio construction (stock selection) is arguably more important for active than passive managers, as deviations from a benchmark determine their success. However, portfolio construction should not be underestimated in a passive context, particularly when passive strategies extend beyond pure index replication.

For example, an asset owner might have a mandate which screens (ESG or non-ESG) out stocks that represent 5% of the investable universe. If the tracking error needs to be kept similar to the pre-screen level, that 5% then needs to be allocated to the other names within the index. The allocation could be divided equally, weighted towards names with better or even worse ESG scores, or with a lower carbon footprint; names with the highest correlation to the stocks removed from the index; or derivatives can be used to create exposures, etc. All options have consequences. Removing holdings with the highest carbon footprints may result in an over-allocation to the lowest carbon performers in the sector or an index, impacting correlations and shifting expected risk and return among other portfolio characteristics. In some cases, such as if countries are removed based on ESG ratings or issues, only a very narrow investable universe may remain. This could hinder portfolio construction by introducing capacity constraints or impacting liquidity.

When it comes to selection, asset owners need to be aware of portfolio construction trade-offs and a manager's ability within these constraints to make decisions that best serve their long-term goals.

### Questions to explore portfolio construction at the firm and product level

- How often do you review or change material ESG factors that inform portfolio construction?
- What are the key considerations after we have granted you a mandate in terms of the investable universe of this product?
- Please describe relevant portfolio construction criteria you use and monitor, and how ESG issues interact with such criteria.
- How will you mitigate ESG risks in the holdings and reflect this in portfolio construction, monitoring and rebalancing? How does firm-level risk research inform portfolio construction?
- If you remove a stock, sector or country from an index, how do you adjust the weight of the remaining stocks and consider ESG issues in the process?

## THEMATIC AND SCREENING APPROACHES

Thematic and screening approaches choose investments in securities that fit into certain criteria and play increasingly important roles in asset allocation considerations. Asset owners should pay close attention to the methodology, rules and accuracy of chosen screens during the selection process.

### ALIGNING EXCLUSIONARY POLICIES WITH INTERNATIONAL CONVENTIONS

One way an asset owner may approach negative screening is to align its exclusionary criteria with the United Nations' system of internationally-agreed conventions. For example, UN Global Compact has recently excluded from its membership companies that participate in tobacco and controversial weapons sectors – leading many investors to also reconsider their involvement. See more on tobacco exclusion on UICC and Tobacco Free Portfolios.

For example, a positive screen where 50% of the top ESG performers are included in an index can be executed by analysing all the stocks in-house, by licensing an index or using ESG scores to design a screened portfolio. A question here would be which process is the asset owner comfortable with and how would choices be reflected in fees charged.

Another example where accuracy would be a crucial element is a negative-screening product where a significant reputational risk item for an asset owner is excluded. How can a manager assure that the portfolio is always compliant? A discussion on the reallocation of an investment that has been screened out would also be needed.

A themed investment screen might target companies where women represent over a certain percentage of management, or bonds that finance social projects. The quality of data used for screening is important, including: the use of ESG ratings (how often ratings are updated); the use of carbon footprinting (scope of the exercise); and the use of indexes that satisfy particular thematic requirements. It is important to understand how managers can overcome liquidity issues in thematic products, funds or indices construction in areas where the underlying supply is limited.

Selection processes targeting alternative or smart beta products must consider how the index, with its inclusion of ESG considerations, alters the desired single or selection of active beta factors.

### Questions to explore thematic and screening approaches at the firm level

- Do you use positive or negative screening? If so, please describe the process – how are screens defined?
- Is the screening binary (negative or positive) or does it assign a different weighting based on which investments are selected?
- What data do you use for screening and who provides it, or is it performed in-house?
- Do you have a cut-off score in carbon or ESG ratings? If so, how is it set?

### Questions to explore thematic and screening approaches at the product level

- Please describe how you monitor your investments and the portfolio for ESG compliance and risks.
- What external data will be used for investment decisions?

## INTEGRATION

Integration relates to the process of embedding ESG considerations into fundamental investment valuation and related engagement, and applying insight acquired to investment decisions. For detailed examples in equity, please refer to the PRI's A practical guide to ESG integration for equity investing. The chapter entitled *Assessing external managers* outlines what asset owners need to know about integration. In the manager selection phase, a key objective for asset owners is to assess the quality of a manager's integration practices against their own expectations.

An intuitive way to ascertain the effectiveness of an investment manager's integration approach is to consider the price of an investment firstly with, and then without, ESG factors accounted for. ESG integration should produce distinct outcomes in asset price, Discounted Cash Flow (DCF) models, credit spreads, internal rates of return, etc. – or an explanation as to why there is no difference. The investment manager should be able to attribute some value and/or have an informed discussion on the topic and why integration is applied – or indeed why it is not applied. Understanding what drives the valuation differential will help asset owners understand the integration process, and sheds light on how the prospective management team plans to select investments.

Activities portrayed as "integration" often merely amount to simple screening, whereas integration done well is a powerful method of fundamental analysis. From a value for money perspective, the importance of understanding integration is heightened as products claiming ESG integration are active products and levy active product fees. It is important that those asset owners that are willing to pay for genuine insight receive such insight and, ultimately, investment performance.

### Questions to explore integration at the firm level

- How are ESG factors integrated into your firm's investment analysis and decision-making processes (e.g. portfolio construction, fundamental sector analysis, stock selection, etc.)?
- How is internal and external ESG data used by the investment team?
- How do you determine materiality and calculate potential investment impact in the short, medium and long term?
- How is the investment team incentivised to integrate ESG factors into investment decisions?
- Please provide examples of valuation with integrated ESG versus standalone financial analysis.
- How do your products that integrate ESG issues differ from those that do not integrate ESG issues?
- Please provide examples of the connection between active ownership activities and ESG integration.
- How do you use ESG information to identify investment risks and opportunities?
- How have you invested in integration competency, processes, staff and supporting infrastructure?
- How will systemic trends, themes or issues be integrated into financial decision-making processes?
- Do you follow an ESG benchmark or index?
- What weighting do ESG factors have on the decision-making process and investment decisions across the firm?
- How do you identify and manage ESG risks and opportunities, and use ESG factors to add value to investment decision making?
- What ESG data, research, resources, tools and practices do you use to integrate ESG factors into investment processes, valuations and decisions?

### Questions to explore integration at the product level

- How are ESG factors integrated into investment analysis and decision making?
- How will ESG information be used by the investment team responsible for this product?
- How is the investment team incentivised to integrate ESG factors into investment decisions?
- Please describe your integrated analysis and valuation process for this product.
- Please list the most material ESG issues and themes that impact the portfolio and outline your views on those issues, their materiality and future trajectory.
- What weighting do ESG factors have on the decision-making process and investment decisions of this product?
- How does this product differ from similar products offered by your peers in terms of ESG performance? What is your competitive advantage?
- Please provide insight into portfolio-level ESG analysis (for example, ESG scores relative to the benchmark, carbon footprinting), including specific stocks or sector decisions which drive under or overperformance.

## IMPACT INVESTMENTS

While still a niche market, impact or environmentally and socially-themed investment volumes have grown considerably over the last decade. Indeed, the PRI is currently working on an [Impact Investing Market Map] that gives information about 10 types of impact investments. The map helps investors understand the criteria that can be used to identify if and how these investments contribute to sustainable outcomes.

Asset owners that wish to include impact investments in their portfolios should seek to understand how their managers define impact and how they seek to measure such impact. One problem facing the industry is the branding of certain funds as impact investments without a clear link to impact contribution. It is therefore vital that asset owners help to maintain the integrity of the market by choosing products and funds that genuinely deliver positive impacts. Impact investments tend to be concentrated in private equity and debt investments.

### Questions to explore impact investments at the firm level

- What tools or performance standards do you use to measure impact?
- What is your process for determining materiality and calculating potential investment impacts and real world impacts in the short, medium and long term?

# ASSESSING ACTIVE OWNERSHIP THROUGH ENGAGEMENT AND VOTING

This chapter looks at how asset owners can be effective stewards of their assets and, if such functions are outsourced, determine how an investment manager deals with stewardship and active ownership issues. The topic of active ownership is split into engagement and voting. Both activities have distinct characteristics that asset owners should be aware of in the selection process.

| DEFINITIONS | |
|---|---|
| **Active ownership** | Active ownership is the use of the rights and position of ownership to influence the activity or behaviour of investees. This can be applied differently in each asset class. For listed equities, it includes both engagement and (proxy) voting (including filing shareholder resolutions). For other asset classes (e.g. fixed income), engagement may still be relevant while (proxy) voting may not. |
| **Engagement** | Engagement refers to interactions between the investor and current or potential investees (which may be companies, governments, municipalities, etc.) on ESG issues. Engagements are undertaken to influence (or identify the need to influence) ESG practices and/or improve ESG disclosure. |
| **(Proxy) voting and shareholder resolutions** | Voting refers to voting on management and/or shareholder resolutions as well as filing shareholder resolutions. |

## ENGAGEMENT

Asset owners can engage with companies on three levels:

1) Direct engagement.
2) Collaborative engagement (may include asset owners and investment managers and is unlikely to be the sole method of engagement).
3) Outsourced engagement:
   a. carried out by an investment manager (who may sub-contract to service providers); or
   b. carried out by a specialist service provider (directly contracted by an asset owner)

### COLLABORATIVE ENGAGEMENT

It is often the case that a single asset owner or manager represents a very small part of a company's overall capital. A group of investors of the same standing therefore tends to have a higher chance of engaging successfully compared to one single voice.

Collaborating with peers also facilitates the dissemination of best practices across the industry. Insight from peers can give asset owners confidence during the selection process to identify whether an investment manager is lagging or setting an example in engagement. Understanding collaborative engagement tools the investment manager may use, such as the PRI Collaborative Engagement Platform, can also aid the selection process.

**Questions to explore collaborative engagement**

- Do you have a structure in place to collaborate with peers on company engagement? Please give recent examples if so.
- How do you exchange best practices with peers and help disseminate these?

### OUTSOURCED ENGAGEMENT

The process that an investment manager uses to engage, as well as its perceptions of engagement, should always be assessed. Does it see engagement as a fee-sapping evil or as a genuine opportunity to add value? It is also important to understand the semantics around engagement and voting, as some managers may promote pure voting activities as engagement. Engagement activities can directly impact financial performance.

Equally, asset owners must understand a service provider's intentions (whether that service provider is a manager or an engagement specialist mandated for the task) when they engage. An investment manager's engagement should arguably always be instrumental to stronger investment performance, whereas a service provider's (a pure engagement provider) engagement approach can reflect a wider set of drivers in asset owners' strategy and policies.

If a purely instrumental view is held, an asset owner should measure the cost-benefit ratio of the engagement activity it is willing to support. It is important that asset owners explore what motivates them to engage and then ensure that that perspective is followed through. An asset owner may outsource engagement if a product does not offer an engagement overlay or share their motivations for engagement. It is also possible that a manager does not address engagement needs but provides investment products that incorporate ESG factors into investment decision making.

Asset owners should ask for examples of how a manager's engagement approach is structured. Identifying the individuals responsible and understanding the processes involved is a good first step, with ascertaining how those individuals interact with investment decision makers a good second step. Examples of recent engagements and their outcomes are useful in assessing a manager's engagement capability. It is also important to understand if engagements are initiated across all the manager's assets. If the manager outsources engagement to a third party, asset owners should ask about the terms of the arrangement and the sustainability of it.

Beyond targeted engagements, asset owners should analyse the relationships a manager may have with the firms it invests in. It is rare (but possible) that routine analyst and portfolio manager dialogue already covers ESG issues and no further engagement is therefore required. Asset owners must be confident of staff ESG competency in such a case. It is also unlikely that principles-based issues are considered in engagements that are driven purely from a portfolio management perspective.

**Active versus passive**
Asset owners should have the same fundamental perspective on engagement regardless of whether an active or passive strategy is in question. Passive products are often chosen to limit the cost of managing assets and any engagement overlay may negate that. However, it could be argued that the stewardship role an asset owner assumes by investing on beneficiaries' behalf has a cost implication – in the same way as does the management and administration of a fund. Therefore, engagement costs are part of running asset owner activities. This is particularly true when it comes to voting (discussed ahead). The old adage "if you can't sell, you must care" to safeguard your investments further encourages long term passive asset holders to engage. They have a general interest to manage negative externalities (such as corruption or climate change) which could damage the economy or sector in question.

Meanwhile, passive investments are not necessarily blind. For example, factor investing can be considered as passive, although such investments do not follow a benchmark blindly – meaning all investment decisions are essentially active. With such strategies, engagement on specific ESG issues can and should be implemented, and the selection process should consider a manager's approach to this.

**Using service providers**
When engaging through service providers, asset owners should ideally define topics to raise, as well as companies to target and objectives to achieve (this may be done via a policy or as a more hands-on, one-off exercise). Asset owners must reference topics and goals during the selection process and then monitor providers based on what has been agreed. Asset owners should be ready to participate in some of the engagements they care most about and establish in the selection and appointment process how such arrangements will work.

### Questions to explore engagement at the firm and product level

- How do you engage with companies on ESG issues?
- Is the engagement process structured or is it handled on a case-by-case basis?
- How do you use ESG portfolio information to identify opportunities or targets for engagement?
- How do you ensure ESG factors are integrated into investment decisions, including insight gained from engagement activities?
- Please give evidence of a connection between active ownership activities and portfolio-specific alterations in investment decisions.
- How will you engage with companies on ESG issues for this product if it differs from your firm-level practice?
- How does information from engagement affect investment decisions for this product? Please give examples.
- How are you planning to use engagement service providers for this product, and how will you ensure they meet our needs?
- If you use service providers as consultants, do you have a policy to provide focus for those providers and clearly outline what is expected of them?
- Would you consider disinvesting from a company that does not respond to shareholder engagement?
- What are your service provider's commitments regarding ESG expectations and are they able to handle differences among various asset owners' policies?

Asset owners must also make extra effort during the selection process to verify how portfolio managers and analysts responsible for making investment decisions receive the information collected through engagement activities.

### SELECT ENGAGEMENT STUDIES

- Elroy Dimson, Oğuzhan Karakaş and Xi Li analysed CSR engagements with US public companies from 1999-2009 on ESG issues in the Review of Financial Studies (volume 28).
- Gordon Clark, Andreas Feiner and Michael Vies' From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance includes a chapter on active ownership.
- Paul Gompers, Joy Ishii and Andrew Metrick find that responsibility and profitability are "complementary" in Corporate Governance and Equity Prices.
- See Terry McNulty and Donald Nordberg's Ownership, Activism and Engagement: Institutional Investors as Active Owners.

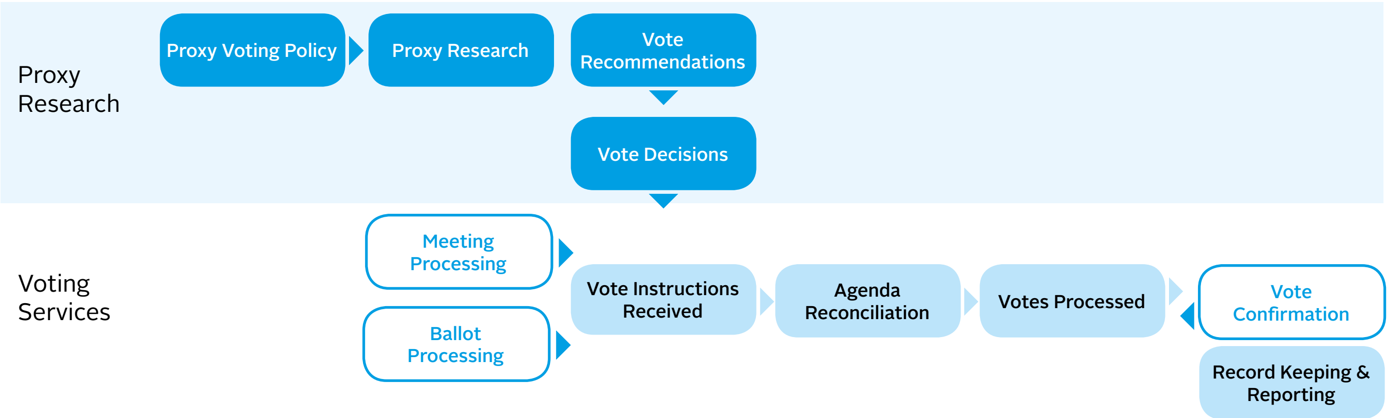
## VOTING

There are often two starting points associated with voting:

1) An asset owner has its own voting policy in place and looks for an investment manager that can implement it via:
   a. segregated execution (shareholder rights remain with the asset owner);
   b. pooled execution (shareholder rights remain with the investment manager and it is rare for an asset owner to impose its voting policy on such funds).
2) An asset owner does not have a distinct voting policy and relies on an investment manager's standard voting practices, regardless of the fund structure.

When selecting a manager, asset owners should ask about the voting process, including in terms of quality and suitability of execution, as well as any professional parties involved.

**Figure 5: An example of a common voting chain for a segregated account structure**




In the voting chain, a policy – from an owner or a manager – forms the basis for all voting under regular circumstances. Asset owners or managers then often appoint proxy service agencies to help them formulate voting recommendations for specific issues and/or companies based on the overarching policy. Actual voting decisions are then made based on the proxy research recommendations and other factors such as feedback from engagement activities. Future voting intentions, if ascertained in good time, may inform engagement activities ahead of any meeting.

For the actual AGM vote, voting decisions are passed into execution where another set of service providers are engaged to execute the vote and confirm that that vote reaches the ballot. The voting chain reverses and the results are reported to an asset owner and/or manager for further considerations, including commencement or ceasing of engagement activities and/or input into investment decision making, with the potential for divestment.

From a selection perspective, asset owners need to ensure the mechanistic aspects of the voting chain function properly, that quality service providers are obtained and votes reflect their target(s). Voting can become a technical and complex issue with potentially multiple jurisdictions involved. Asset owners must also ensure that all insight gained during the process is incorporated into future decision making across their assets.

## VOTING POLICY

Asset owners should have an investment policy in place that includes their active ownership perspective, with voting a key component. The PRI's recent report, Investment Policy: Process & Practice - A Guide for Asset Owners, outlines how to formulate and review a policy. A clear policy makes any service provider or manager selection process easier – to a simple question of how well they can implement the policy. Focus will be on the processes described previously, effectiveness of voting (cost and impact) and responsiveness of the process. Asset owners must determine whether a manager has the capacity in-house and/or a quality third-party service provider retained.

In a situation where an owner's voting policy is clear, the chosen investment product plays a key role. With segregated products, effecting an asset owner's policy is a relatively straightforward task. With a pooled product, an asset owner should still endeavour to include its voting policy directions. An investment manager's ability to adhere to potentially diverse instructions would then become a key differentiator in selection or an asset owner would need to find a pooled product where the manager's voting policy aligns with its own policy. Groups of smaller asset owners can develop a customised voting policy and ask a manager to implement that policy for the percentage of holdings they collectively have in the fund. Flexibility for such activity would need to be addressed during the selection process.

If an asset owner is unclear about its own voting policy, or does not have a policy and is searching for an investment manager to vote on its behalf, the underlying manager voting policy needs to be examined. Any discrepancies between an owner's views – in cases where an owner has no policy – and a manager's policy need to identified. Any misalignments should manifest during the selection process and potential solutions should be discussed.

### Questions to explore voting policy at the firm level and product level

- Do you track which strategic changes in corporate actions are attributable to voting outside the default options, e.g. a vote against a general AGM agenda item?
- Do you evaluate proposed company directors before the AGM/EGM? What process does this involve?
- What actions have you taken to support ESG-related director appointments or to remove directors associated with ESG-related failures?
- How will you ensure that our policy is adhered to in all situations?
- Have you (co-)issued any shareholder resolutions at AGM/EGM events? Please give some examples, and the results of the resolution.
- How will you act in a situation of misalignment between your standard voting policy and ours?
- Are there are any voting options you do not want to implement in your own name?
- Have you supported previous activist stances by other investors with regards to board nominations and proxy access? Please give examples.
- How may I vote against director appointments in the context of this product?
- What capacity to evaluate company directors will be available for this product?

## VOTING PROCESS

On the basis that an asset owner has a clear view on what voting should achieve, the next stage is to find a manager with a robust voting execution process – from registering instructions to reporting on voting outcomes. An investment manager that cannot cast two different votes for separate funds would probably be unsuitable for an asset owner seeking to strictly implement its own guidelines. Securities that are not segregated cannot generally be voted on separately; the segregation process would be lengthy and might incur an additional fee. Dynamics like these need to be well understood and accounted for in the selection phase and weighted against an asset owner's voting requirements.

An investment manager may have in-house voting capabilities or it may outsource to service providers. It is also important to understand how, or if it is possible, for an asset owner to potentially bring voting in-house or keep voting back altogether under special circumstances.

### Questions to explore the voting process at the firm and product level

- What are your proxy voting guidelines and do you vote on behalf of asset owners?
- Is a structure where the asset owner retains its voting capability available? If so, how does it function?
- How do you separate funds with potentially different voting guidelines?
- How do you approach potentially different ownership rights across assets and asset owners?
- Do you separate shares for different votes to allow for asset owners' voting guidelines to be adopted, or are all votes for all holdings in that company the same?
- In delegated voting decisions, do you use a consultant or an in-house team?
- For this product, how do you approach potentially different ownership rights across asset classes and asset owners?
- How will you ensure that our voting policy is consistently deployed?
- Who is responsible for the voting process?

## VOTING OUTCOMES

Beyond checks and balances on whether votes were registered and reached the ballot, evaluating voting outcomes should take place at the company and portfolio level. Voting against increasing the compensation of management that is failing to deliver is a standard example. An asset owner can question if a vote was successful in reducing the compensation, or preventing an increase, and how an unsuccessful vote changes future activity (such as a change in directors or blocking re-election of the compensation committee). An unfavourable outcome might lead to the portfolio weight of the stock being reduced. A higher allocation or assigning higher ESG ratings to more responsive companies is an alternative if a positive outcome is reached. The selection process should show how an investment manager can deliver basic outcome information to an asset owner as well as inform its own decision-making process and how voting impacts this.

### Questions to explore voting outcomes at the firm level and product level

- Please explain how information acquired from voting is translated into investment decisions, with examples of previous cases.
- Are the results of those votes public or private, and are they measurable?
- If you vote on behalf of asset owners, what has been the track record of voting against management? What process led to that vote?
- Would a responsive management team, which acts on your voting, lead to a larger allocation to the company versus its peers?
- How much say will we have when it comes to disinvesting or reducing allocation from our portfolio in the context of this product?
- How will you measure specific engagement results for this product? Will they be publicly available?

## SECURITIES LENDING AND DERIVATIVES

Some investment managers lend equity and bonds to boost portfolio returns by the margin earned from lending. If those securities are not recalled in time to exercise voting, the borrower is entitled to vote them. Negative publicity might result in controversial votes in stocks with concentrated ownership. Similarly, selecting a product that provides synthetic exposure to a stock or an index through a derivative might not come with voting rights. Buying into an ETF would typically mean no voting rights on the underlying securities. While these questions mostly affect and should be dealt with at the general investment policy level, the selection process can shed light on how investment managers can help to manage such issues.

### Questions to explore securities lending and derivatives at the firm level

- To what extent does your strategy allow for securities lending?
- To what extent does your strategy allow the use of derivatives?
- To what extent does your strategy allow for off-balance sheet exposure?
- What is your approach to securities lending? What influence will you give us in this context? How will you ensure that our voting policy is executed across all of our securities?

# REPORTING

The selection process should consider the ongoing reporting from the manager to the asset owner and satisfy the latter's internal investment-related information requirements, as well as be able to accomodate their own reporting to stakeholders.

An investment manager's external reporting covers all directly published information, as well as items where information is contributed to public reporting platforms (such as the PRI Reporting Framework). Naturally, some information is not public and only available to certain clients.

The public reports, newsletters, fund performance reporting of investment strategies and other public information showcase an investment manager's capabilities. PRI Transparency and Assessment Reports provide further information on the subject. Asset owners, or their consultants, should thoroughly review public information in the longlisting stage of manager selection and avoid asking more general questions later on. Asset owners should instead be specific in their requests and raise KPIs and other issues in direct exchanges with managers.

In the same way that asset owners can use the PRI Reporting and Assessment Framework to obtain information about prospective investment managers, investment managers can use it to gain knowledge about asset owners. In addition, public information on an asset owner's website and annual reports may provide information on the asset owner's investment strategy and policy.

### Questions to explore reporting at the firm and product level

- Please provide reports reflecting ESG integration activities, performance and impact. What is the level of detail and frequency?
- Please demonstrate how you communicate ESG integration performance to your stakeholders (e.g. to executives, the board, investors, staff, consultants, service providers and intermediaries).
- Please explain how your ESG process relates to the PRI Reporting Framework.
- What performance indicators do you use to measure and report on your ESG impact?
- Are you willing to share your PRI Transparency and Assessment Reports with us?
- Please provide an exsample of how you would like to report to us about the performance of this product.
- What performance indicators will you use to measure and report on ESG impact or integration for this product?

# PRACTICAL TIPS FOR MAKING SELECTION DECISIONS

This guide has so far focused on the various areas to evaluate when assessing a manager's ESG-related investment approaches and capabilities. This final chapter offers practical ideas for bringing ESG matters raised during the manager selection process together in order to facilitate ultimate decision making. It takes into account generic models for the manager selection process, the organisational ownership structure of ESG assessment and scoring methodologies.

## GENERIC MODELS FOR THE MANAGER SELECTION PROCESS

There are several overviews of the manager selection process that asset owners can refer to, primarily from organisations offering manager research and selection services.

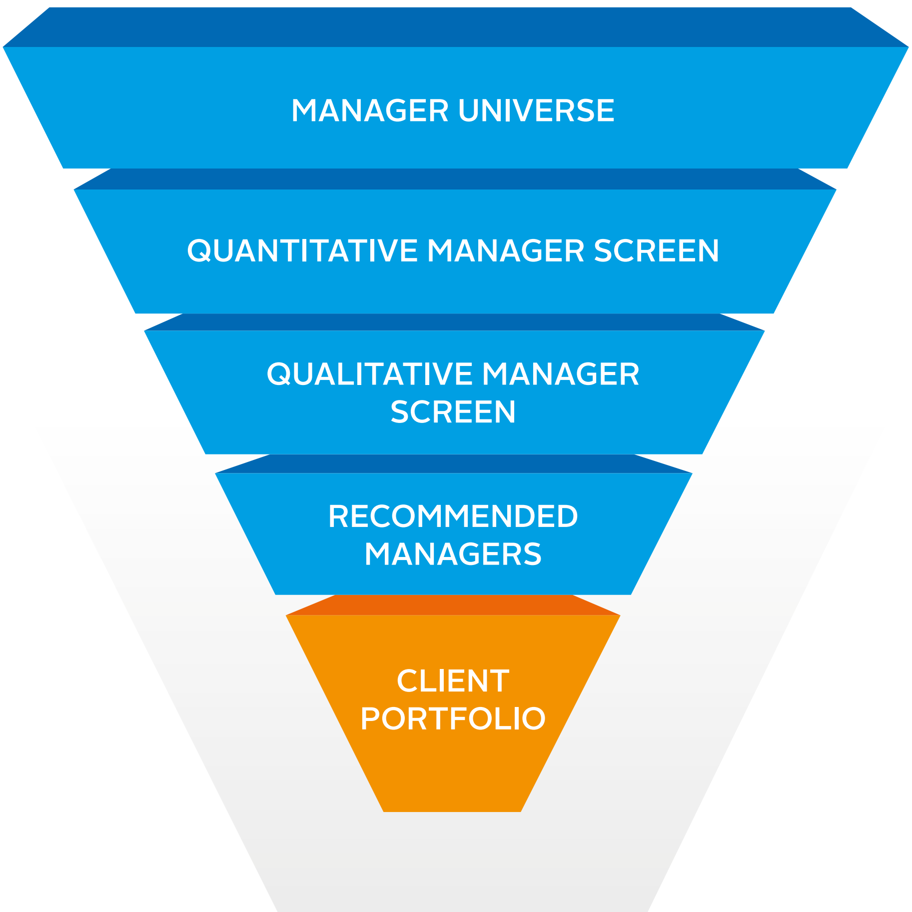
Such models tend to feature four or five stages and can be generically described as the following:

1. Identification of the manager universe (qualification)
2. Quantitative screening (creating a longlist, verification of the information)
3. Qualitative screening (creating a shortlist, RfPs)
4. Due diligence visits (analysis of the shortlist)
5. Portfolio inclusion

The content and descriptions of each stage will depend on the organisation in question - its philosophy and the competitive advantage being promoted. The areas of focus within each stage are also fluid depending on an organisation's overall investment approach.

We see value in all approaches and this guide has highlighted areas of exploration when it comes to understanding the role of ESG in manager selection, without outlining a standard process. The areas covered can fall into various stages in different taxonomies.

**Figure 6: General manager selection process model. Source: The PRI**



## SCORING METHODOLOGIES

While the stages of manager selection may flow differently among organisations, there is common ground when it comes to methods of assessment. A scoring system based on various dimensions should be developed with weights that correspond to organisational priorities. Scorecards will vary in complexity, structure and levels of narrative.

**Figure 7: A simplified scorecard example (with common headings identified in selection criteria research).**

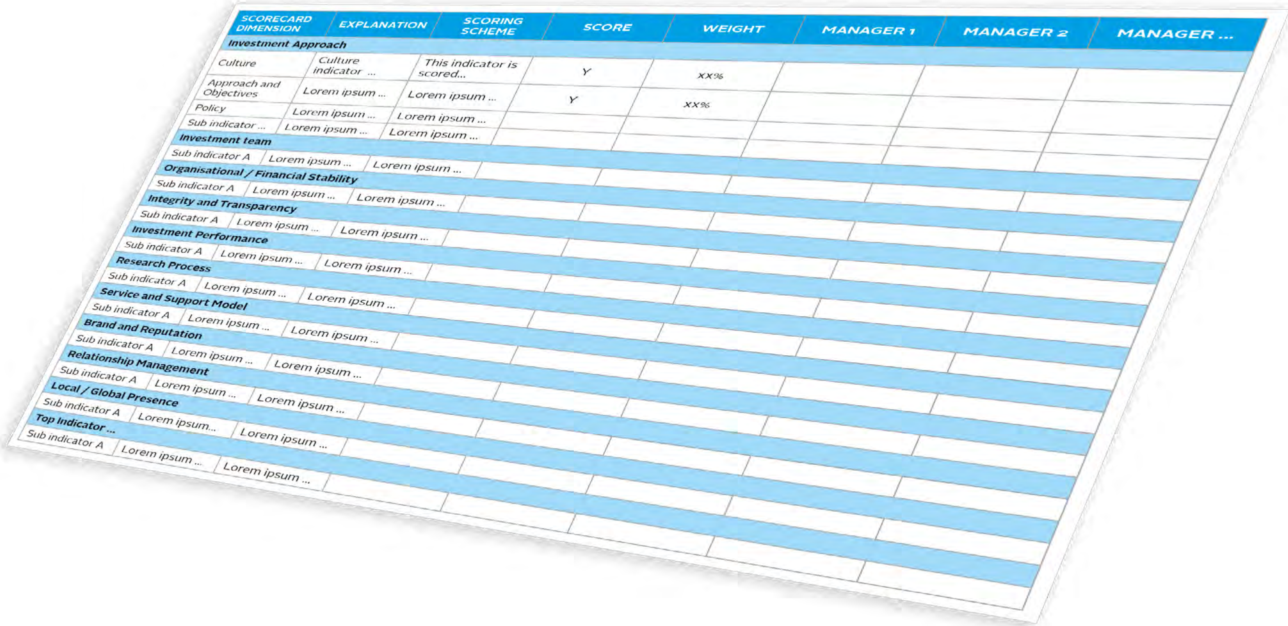



**Figure 8: Regional differences in asset manager selection criteria. Source: Market Strategies International.[2]**

| Rank | UK | US | Nordics | France | Germany | Italy | Netherlands | Switzerland |
|---|---|---|---|---|---|---|---|---|
| 1 | Organisational stability | Local presence | Integrity and transparency | Brand and reputation | Financial stability | Research process | Research process | Brand and reputation |
| 2 | Investment team | Investment philosophy | Investment performance | Financial stability | Investment performance | Financial stability | Product innovation | Investment performance |
| 3 | Financial stability | Research process | Assistance with regulatory compliance | Service and support model | Research process | Assistance with regulatory compliance | Third-party external ratings | Investment team |
| 4 | Integrity and transparency | Investment performance | Investment team | Organisational stability | Alignment | Local presence | Local presence | Local presence |
| 5 | Investment philosophy | Service and support model | Brand and reputation | Investment philosophy | Relationship management | Investment philosophy | Service and support model | Financial stability |

2 Cogent ReportsTM International Institutional Investor BrandscapeTM. August 2016

## ESG SCORING

When it comes to scoring ESG capabilities, considering and assessing the elements discussed in this guide, asset owners have two main options:

- **Integrated approach**: ESG scores are integrated into a scorecard of all or several dimensions via sub-indicators, with indicator explanations and scoring schemes describing desired ESG-related behaviours.
- **Standalone approach**: A specific ESG selection scorecard with its own indicator explanations and scoring schemes to be integrated as a dimension in the overall manager selection scorecard.

Given the relatively nascent nature of ESG, best practice is typically approached in a standalone manner, driven by dedicated teams or individuals. This has ensured ESG insight is given sufficient exposure vis-à-vis more integrated selection elements, prompting ESG as a discipline to gain wider organisational acceptance and allow ESG competence to expand.

A standalone assessment could involve sending a reporting or selection questionnaire to a prospective manager (or an existing manager if regarding an appraisal) and then benchmarking it against a universe of managers.

A process tool uses the below heat map to assess individual manager scores.

The *Wespath Analytical Insights - ESG Integration Evaluating and Monitoring External Asset Manager Performance* report also provides questionnaire examples, indicator definitions to use in assessments and further elaboration of using the process as an annual assessment of managers' ESG competency.

In organisations where ESG efforts operate as a distinct pillar of the overall investment function, the team or individual responsible generally designs and conducts ESG-related selection due diligence. Although this bodes well for resource allocation efficiency, ESG staff should act in a consultative manner with other investment teams and/or staff responsible for the full selection process for ESG to become a more integrated activity.

**Figure 9: Sample of individual manager assessment. Source: Wespath's 25 ESG Indicator Framework (active managers)**

| **1. Policy and Resources (25%)** | **Firm Level** | | | | | | |
|---|---|---|---|---|---|---|---|
| ESG Policy (20%) | E,S,G + ✓ | Materiality ++ ✓ | Active Ownership ++ | Integration Process +++ | Oversight ++ ✓ | Refreshed + | PRI Signatory + ✓ |
| Dedicated Resources (5%) | Collaboration and Initiatives + | Use of External Resources + ✓ | Dedicated Personnel ++ | | | | |
| **2. ESG Integration (50%)** | **Strategy Level** | | | | | | |
| ESG Strategy (50%) | E,S,G + ✓ | Materiality ++ ✓ | Risk and Opportunities ++ | Influences Decision Making +++ | Systematic/ Process Implementation ++ | Knowledge Building ++ ✓ | ESG Reporting +++ |
| **3. Active Ownership (25%)** | **Firm and Strategy Level** | | | | | | |
| Engagement (12.5%) | E,S,G + ✓ | Strategic +++ | Impact +++ | Public Policy + | | | |
| Proxy Voting (12.5%) | Own Guidelines +++ | E,S,G + | Active Voting +++ | Assurance + ✓ | | | |

| +++ | ++ | + |
|---|---|---|
| Primary indicators | Secondary indicators | Tertiary indicators |

**Figure 10: Sample performance snapshot. Source: Wespath**

| Performance snapshot: external public equity managers | | | | | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Managers | A | B | C | D | E | F | G | H | I | J | K | L | M | N | O | **Manager** | P | Q | R |
| **1. Policy and Resources** | | | | | | | | | | | | | | | | | | | |
| ESG Policy | | | | | | | | | | | | | | | | | | | |
| Dedicated Resources | | | | | | | | | | | | | | | | | | | |
| **2. ESG Integration** | | | | | | | | | | | | | | | | | | | |
| Integration Strategy | | | | | | | | | | | | | | | | | | | |
| **3. Active Ownership** | | | | | | | | | | | | | | | | | | | |
| Engagement | | | | | | | | | | | | | | | | | | | |
| Proxy Voting | | | | | | | | | | | | | | | | | | | |
| **Overall Score** | 100% | 100% | 98% | 97% | 86% | 79% | 78% | 75% | 69% | 67% | 61% | 55% | 42% | 34% | 30% | 30% | 19% | 19% | 13% |
| **Momentum** | ↑ | ↑ | N/A | ↔ | ↔ | ↑ | ↔ | ↔ | ↑ | ↔ | ↔ | ↑ | ↑ | ↑ | ↑ | ↔ | ↑ | ↔ | ↔ |
| **Category** | **Race Leaders** | | | | | **Chasing Pack** | | | | | | | | **Starting Grid** | | | | | |

## ESG ANALYTICS, FUND RATINGS AND ONLINE TOOLS IN SELECTION

Asset owners now regularly deploy ESG fund ratings and analytics tools, supplied by several large and small data providers, in manager selection. Ratings are available for equity and fixed income products and cover a considerable volume of funds available. Analytics tools allow asset owners to compare funds at multiple levels of granularity – from an aggregated ESG score down to a detailed sub-category item under a specific indicator. Analytics tools allow highly customisable information searches and can provide ESG momentum information. Tools can be used in any context - whether the focus is on an ESG-specific fund or a non-ESG strategy. Findings may be surprising and highlight a lack of ESG integration in ESG-branded funds or a seemingly high ESG component in non-ESG products. ESG views can be part of regular fund assessment tools or specialist tools for ESG. Tools can integrate factor analysis to supplement fund fact sheets and help asset owners understand how the ESG characteristic of a fund interact with other fund dimensions and performance attribution.

Some scoring products rank funds in peer group percentiles of individual E, S and G scores or carbon intensity. Rankings may be relative to all funds or a specific peer group. Rankings and/or analytics can offer insight on the potential impact of a fund, seek to help clarify ethical perspectives or give insight on concentration of ESG risks.

When an analytics tool or fund rating is used, it is crucial that the asset owner is familiar with the service provider's methodology that underpins all assessments. For example:

- Methodologies can rate individual funds by assessing underlying holding ESG scores, either as an aggregation or split into separate component parts, and provide an ESG snapshot based on a point in time.
- Methodologies may compare and analyse the investment processes of management firms in question and bring that information into fund scoring.
- Combined approaches of the above.

Asset owners need to decide what type of analysis satisfies their needs. Methodologies and products are still relatively new but are developing and maturing rapidly (e.g. greater coverage of number of holdings in a portfolio, inclusion of process parameters, greater number of data points, timeliness of underlying data, dynamic content). Rating and analytics products tend to concentrate on the backward-looking ESG data footprint of a defined subset of issues in a portfolio. While such ranking or rating products offer easy, relatively low-cost access to a high volume of quantitative data, the approach can potentially be criticised for its simplicity and sometimes unintentionality of conclusions.

It is likely that a combination of data and analysis from various perspectives will benefit an asset owner seeking to incorporate ESG factors into its portfolios more so than adopting a single methodology. Ranking or analytics products will benefit from cleaner and more accurate external data provision adopted by corporates entities. The value-add and accuracy of these offerings is likely to increase over time.

In addition to the proliferation of portfolio analytics, asset owners can now access several digital selection tool platforms. These services integrate ESG questions and questionnaires across all asset classes in addition to their core selection functionality. The aim of these services is to allow asset owners to interact with managers and exchange data to more efficiently perform traditional due diligence.

## CREDITS

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## The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

PRI Principles for Responsible Investment

**The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.**

## United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UNEP FINANCE INITIATIVE

## United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org

United Nations Global Compact