ESG Dialogue Turning to Action

Pushed by institutional asset owners, more companies get on board, but lack of consistency hampers wider adoption

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The U.S. withdrawal from the Paris climate accord notwithstanding, the ESG investing movement continues to gain steam as asset owners, money managers and other financial industry players seek to invest their assets with well-run companies that are working toward long-term sustainability. In this round table, Keith Dixson, head of international development at Candriam Investors Group, Stephen Harvey, chief operating officer at Institutional Shareholder Services and Vivek Tanneeru, portfolio manager at Matthews Asia, discuss the costs and challenges of building an ESG-compliant culture, the critical importance of engagement, the need for standardized reporting metrics, and where and how Asia leads the world in ESG.

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Pensions & Investments: It seems everybody wants to say they are doing ESG and to be seen doing ESG, but are most plan sponsors and other institutional asset owners really walking the walk? What about companies and asset managers?

STEPHEN HARVEY: ISS is seeing real growth across the whole community: asset owners, managers and companies. Historically, it was the asset owners who had a long-term horizon. They were thinking generations ahead in some cases. So ESG was seen as a particularly important risk factor. That's had a ripple effect with asset managers. More recently the advent of the growing wealth of millennials, who really care about the impact we are having on society and the environment and are living through it, has accelerated the adoption. And as the investment community gets behind the growing area of responsible investing, there's pressure on companies to disclose, to have meaningful dialogue around ESG issues and to recognize that there could be a cost of capital in not having transparency and not representing a vision around the impact they have.

KEITH DIXSON: We've been doing this for 20 years and we've witnessed the evolution of how it started in the institutional space — as a regulatory-driven, government-directed initiative — and evolved into a core focus among all investors, particularly in the retail space. If you look at U.S. investors as an example, today less than 1% of the total capital of the 50 largest public pension plans is allocated to ESG strategies. That's just a simple statistic to illustrate that although there is a lot of talk about it, capital actually put to work thus far is a low number in dollar terms.

In Europe, the majority of fund managers are incorporating ESG into their investment process. In the U.S., it's more around 30%. It's been improving, with an increase of about 5% a year for the last two or three years, so the U.S. is catching up. Its adoption is strongest in foundations — just shy of 80% have some sort of ESG statement or consideration — then it drops off pretty dramatically, to 40% for endowments and around 25% for public pensions. Corporate pensions are at about 15%. So it depends on where you are in the world.

VIVEK TANNEERU: What we're seeing in Asia is a very strong top-down emphasis on better governance and better stewardship. You're seeing governments in places like Japan and Korea and India actively introducing legislation that drives the ESG agenda forward. They are also directing the sovereign wealth funds and the large state-run pension funds to focus on ESG factors. And you also are seeing stock exchanges getting into the act with comply-or-explain.

As Asia becomes wealthier, people are seeking a better quality of life. It could be seeking less polluted air and water, it could be a desire to consume better, high-quality products, medicines that they know will work, etc. And that's really directing more companies to take notice and introduce products and services that are really addressing those needs of consumers.

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>
> **— STEPHEN HARVEY,** ***Institutional Shareholder Services***

P&I: Is it still challenging and expensive to build a truly ESG-compliant culture?

DIXSON: It can be expensive, but most company boards and CEOs have now understood the multiple benefits it brings to their organizations over the long term, either internally or from a business standpoint. Companies are addressing social and environmental matters through a variety of means — firm-specific initiatives, industry self-regulation, working with groups like NGOs, campaigning and ongoing engagement. For asset managers to put in place the appropriate structures to be able to engage with companies requires a committed level of resourcing — and that can be quite costly.

HARVEY: ISS is seeing a material swing toward creating a mechanism to allow private equity firms to articulate how they're managing their investments from an ESG

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perspective. It's less about expense and more about commitment. From a company's perspective, you've got to accept that this is important. You need to have the expertise, and you've got to put the time into it. But I think the biggest need from companies that we're hearing is, 'Let's have a consistent framework based on business practices that we can adhere to so that we're not getting inundated by different requests from different constituencies.'

P&I: Vivek, are there areas of ESG where Asia is leading the rest of the world?

TANNEERU: Asia leads the world in several environmental technologies. One such area is electric battery technology. Chances are that battery cells in virtually every electric car you see on the road today, no matter which make or model, were made by an Asian manufacturer.

India and China together have two to three times the installed capacity of solar and wind generators of the U.S. In just nine months of last year, China installed more solar capacity than the entire installed base of the United States at the end of 2016.

Asia also leads the world in critical ESG areas like financial inclusion and affordable health care, especially generic pharmaceutical manufacturing. So that really tells you the leadership role that Asia has taken in solving global ESG issues. It would be very hard to solve global ESG issues unless they are effectively addressed in Asia.

P&I: Is there anything that hasn't shown up yet in the data that you think might be an opportunity for investors to look for coming out of Asia?

TANNEERU: Yes. One important example is the multimodal mass transit story that is playing out in China. In an effort to address congestion, gridlock and pollution, China has built the world's largest high-speed train network. The network has changed the nature of transportation and has really improved the quality of life for people. Today, for the price of an apartment in town, you can now move 30 minutes out of town to get more living space, which is literally 70 miles away. Quality of life has gone up while your commute time has not changed. And chances are that your disposable income has gone up too. Investors know the high-speed train network is there, but I think they underappreciate what kind of second-order impact it has had. This is slowly beginning to play out in other large cities of Asia too.

P&I: How has engagement become central to bridging gaps between institutional investors and their portfolio companies?

HARVEY: It's become such a focal point, particularly in the U.S. and Europe, and increasingly in Asia. Success here takes the form of a high-quality dialogue that gives the investor an opportunity to voice a perspective to a company and where both parties agree on a path forward without adverse publicity and without confrontation. The biggest challenge is that many investors have pretty large portfolios, so they need to have flags that tee up the companies where there is potentially a problem and then focus on those firms. Active high-quality engagement has become a key part of the dialogue between major investors and their portfolio companies.

DIXSON: Big institutions really have the potential to create change in our world. We're very much of the belief that capital markets are a very powerful force and we can use that force for change if we engage with the portfolio companies on the right topics and in the right way. We view engagement very much as an active form of management.

P&I: What are the limitations of ESG benchmarks that are used now?

HARVEY: The two biggest limitations are consistency and quality. If you're an investment manager that's making a judgment or engaging with a company based upon a rating, you need to be 100% certain about the credibility of that data and methodology that drives that rating. In some emerging markets it's very hard to get the consistency of data required to build a model or flag companies in a portfolio. So one of the biggest challenges is broadening coverage in a way that ISS can cater to global asset managers.

If you're a global asset manager, you might have a portfolio of 10,000 securities. You're not going to engage with every single one of those companies. What you're looking for are triggers that help you identify where there's the most risk from an ESG perspective and then provide a way to make decisions about or engage with those companies where there's risk.

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TANNEERU: Like Steve pointed out, the quality and oftentimes the extent of the coverage can be lacking. Only about 20% of the names in the Asia universe are covered by big data providers. The way we try to mitigate that is by collecting the data ourselves. So we have a large investment team that is focused on Asia. We have about 2,500 company meetings a year. That provides us a great platform to gather information — and engage with the portfolio companies.

P&I: How are companies doing with ESG-related reporting? How helpful have the United Nations' Principles for Responsible Investment and the Sustainability Accounting Standards Board been?

DIXSON: This is probably the biggest challenge. There really isn't standardized reporting for some of the soft ESG items. The likes of UNPRI have helped in gaining acceptance with signatories from asset owners and, more recently, asset managers. There are over 100 ESG rating agencies but no consistent way to display the information. Companies are getting better at reporting, and asset managers better at requesting, but we still have a way to go. We need to move it forward to make it more standardized.

HARVEY: I also think this is what companies are asking for: global standards for sustainability or non-financial disclosure in terms of what data to provide and how to provide it.

P&I: Are there any other common gaps or challenges or mistakes that you see when engaging companies on ESG issues?

DIXSON: It really depends on the specific industry and business model, and this is why we feel sector-specific ESG analysts are so important.

TANNEERU: I think some of the challenges companies have, especially in the small, midcap end of the spectrum as well as in some of the more frontier parts of the Asian markets like Bangladesh, Pakistan or Vietnam, is the lack of resources — financial and human — to go and measure all carbon they emit, waste they generate, and all the water they use. As a result, they might be doing absolutely the right thing by the environment and society, but because they

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don't share it with the world — by way of a glossy report like a large company would — they typically get overlooked.

P&I: How do you incorporate ESG into your investment process?

HARVEY: An acronym ISS uses when we're talking to clients is D-R-I-V-E. At risk of oversimplifying the work that has to be done, it gives you the steps we take when working with a client. One is develop a clear policy around ESG factors. What's important, what's the philosophy, and what are the triggers that you're looking for? Two is to create a meaningful approach to reporting for both clients and other stakeholders, not just reporting for the sake of reporting, but bringing to life what you're doing and the difference that you're making. 'I' is integrating ESG into the investment management process, which is much harder than you would think. 'V' is voting. Voting is increasingly important. Lastly, 'E' is engagement, where both parties are meeting, hearing each other out, and agreeing on a path forward.

DIXSON: We take a very broad set of information and try to distill it down. We rate individual companies, weighting the sectors then ranking the companies within each sector to produce our ultimate ESG universe. We generate a single score from that. On top of that we're overlaying our sovereign analysis so as not to invest in companies that have revenue-based operations in certain restricted countries. Then we have a set of two exclusionary screens — norm-based and controversial activities. Because we've been doing this for a long period of time, we can track a company's score over time and as we engage with company management.

TANNEERU: Matthews Asia uses a three-part framework. First, we identify investment opportunities with companies that are improving quality of life in Asia while also having positive environmental, social and economic impact. Right now we focus on 27 ESG factors that are particularly relevant across Asia. This is a very flexible approach that allows us to target risks depending on what we see happening in the region.

Once we identify a strong investment opportunity, we employ a scoring card to evaluate ESG quality, management quality, business quality, valuations and cash flows. And the third critical piece of our framework is engagement.

P&I: How do you quantify the impact you have on companies?

DIXSON: We track what the board and management have said about what they are going to do, and we'll monitor whether they execute against what they said. We review more than 200 ESG factors for any given company. Some are more important than others depending on the sector. One of the benefits is when we speak to asset owners and they say they are concerned about performance and the impact of choosing an ESG investment philosophy, we can show the financial return and what we call sustainable alpha — that is the calculation of return generated by the selection of the universe between its original non-ESG version and our ESG version.

HARVEY: ISS has researched companies with poor governance and ESG scores, and those have shown increased volatility and, therefore, increased risk in those companies.

As we consider the potential for alpha, it is worth noting that one sector where ISS has seen pretty rapid growth is quantitative hedge funds, which buy data feeds where they're drawing in all of the ESG data that we have and incorporating that into their model-driven approach to investing. They're finding ways to identify opportunity through ESG data.

P&I: We hear more and more about climate change. What are institutions doing well to address this issue and what remains to be done?

DIXSON: Climate change is the headline of the moment and institutions are moving very quickly with their reporting in response. We differentiate the impact by sector. In the utilities space, climate change is well understood, well-quantified and incorporated into business planning. Compare that with consumer discretionary, consumer staples and information technology, where it's really only at the beginning of the upward curve for companies to quantify and report how climate change will impact their business in a material fashion. But we clearly see an acceleration, probably motivated by the daily questions these companies get from investors on this issue.

HARVEY: ISS sees climate as one of the biggest areas of focus among our clients. They're saying: 'Help me to understand the climate exposure in my portfolio. And then how do I measure the potential climate impact, including physical and transitional risks? And then how do I act? Do I just change out the security? Am I engaging? Do I use proxy voting as a way to make a statement to the company?'

TANNEERU: Some Asian companies are embracing renewables as a way to not only address climate change but also as a way to improve their cost competitiveness. Renewables in general, and solar in particular, have become very cost effective in certain parts of Asia, for instance. Energy efficiency is another key area of opportunity in Asia. One of the things we're trying to do when it comes to climate change and other ESG issues is go beyond exclusion, beyond integration, beyond best-in-class. We are essentially focusing on outcomes and a company's net impact.

P&I: What do you think is the future of ESG this year and beyond? What is the ultimate endgame?

HARVEY: There are several factors to take into account when you look forward. One is the growth beyond equities. We've been historically focused on the equity market, but we're seeing fixed income, private equity and other asset classes really starting to take ESG into account. Also impact investing — investors want to make a real difference. Lastly, I think the real end goal is for the community to come together to maintain returns while protecting the planet. And I think that's what this is all about — across social as well as environmental aspects.

TANNEERU: You have a new generation of people that are being educated for whom it's very natural to think about ESG integration. But as you can imagine, it's a slow process. On the regulatory front, Asian governments have realized the importance of ESG and have introduced legislation promoting it. In particular, Japan started on this in a major way as part of Abenomics. Korea has since followed. India introduced a company law in 2013 that mandates spending on corporate social responsibility initiatives and minimum board independence requirements. These changes are impacting asset owner, investor and corporate behavior in Asia. Ultimately, the end game really is that talking about ESG becomes second nature to everybody.

DIXSON: We see more and more institutions coming around to this systematic consideration of non-financial factors, commonly known as ESG: environmental, social and governance. These are inherently important to the evaluation of long-term outlooks for companies.

Investors that really care about the long-term deployment of capital and loss of permanent capital — pension plans, insurance companies — are going to focus on a company's social license to operate and less on the short- and medium-term profit outlook. Reliability of data is the key impediment to people fully integrating ESG analysis into stock valuation models. We believe you will see a real move from an exclusionary screen approach to more positive screening, where you select the best companies in each sector, and that best-in-class positive screening will prove to be the preeminent approach to ESG. And where active ownership and engagement with companies is going to become much more important. ■

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