Principles for Responsible Investment

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

ESG Incorporation & Investment Strategies in Listed Equity

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PRI

Responsible Investment - Definition

"The PRI defines responsible investment as a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership."

Overview of Investment Approaches

Approaches to Responsible Investment in Listed Equity

ESG INCORPORATION

ESG INTEGRATION

The process of integrating ESG issues and information into investment analysis:

- **ENVIRONMENTAL** – e.g. chemical pollution, water management, greenhouse gas emissions, renewable energy etc.
- **SOCIAL** – e.g. labour standards, freedom of association, controversial business practices ,talent management etc.
- **GOVERNANCE** – e.g. corporate governance issues, bribery, corruption, lobbying activity etc.

ESG SCREENING

The process of excluding or seeking exposure to securities based on investor values or other criteria:

- EXCLUSIONARY (NEGATIVE)
- BEST IN CLASS (POSITIVE)
- NORMS-BASED

ACTIVE OWNERSHIP

Interactions between the investor and current or potential investees:

- **VOTING** (e.g. AGM, EGM or special meeting)
- **SHAREHOLDER ENGAGEMENT** (e.g. Shareholder resolutions, calling an EGM, complaint to regulator)
- **OTHER ENGAGEMENT** (Other engagements on ESG issues: proactive, reactive and ongoing)

Screening: Filtering the Investable Universe

There are three main types of screening…

Exclusionary (negative) screening:

- Excludes sectors and companies, based on:
  - Absolute rules;
  - Relative rules;
- Reduces the investible universe.

Inclusionary (positive) screening & best-in-class screening:

- Actively includes companies that meet an ESG standard;
- Reduces the investible universe but all sectors are investible.

Norms-based screening:

- Screening of investments against minimum standards of business practice based on international norms;
- Reduces the investible universe but all sectors are investible.

6 Key Steps When Using Screening As An Investment Approach

- **Step 1:** Identify client priorities
- **Step 2:** Publicise clear screening criteria
- **Step 3:** Introduce oversight
- **Step 4:** Adapt investment process
  - ABSOLUTE EXCLUSION — No investment in exclusionary criteria
  - THRESHOLD EXCLUSION — Partial investment
  - RELATIVE EXCLUSION — Best-in-class investments
- **Step 5:** Review portfolio implications:
  - Tracking error
  - Style factors
- **Step 6:** Monitoring, reporting and audit

Screens are often based on data, obtained from third-party providers, which feeds into internal order management systems to ensure compliance during portfolio construction.

Screening Processes

Two main types of screening process:

- Done by own staff;
- Outsourced to service provider.

Best practice components of a screening process:

- Quarterly reviews of company ESG research/ratings;
- Quarterly updates of third-party ratings;
- Daily audits of portfolio holdings undertaken by internal compliance function or external service provider;
- External, independent committee or internal committee reviews some or all screening decisions;
- Automated IT systems prevent investments in excluded stocks;
- Systematic process that alerts the portfolio manager, compliance team and ESG team of any breaches;
- Set period for divestment when permitted holding becomes ineligible;
- Rules governing when to engage or when to divest.

What Is ESG Integration?

Definition of ESG integration

"The systematic and explicit inclusion of ESG factors into investment analysis and investment decisions".

What does that mean?

- Analysing financial information and ESG information;
- Identifying and assessing the impact of material financial factors and ESG factors;
- Making an investment decision based on all material factors, including ESG factors.

What does it not mean?

- Certain sectors, countries and companies are prohibited from investing;
- Traditional financial factors are ignored;
- Portfolio returns are sacrificed to perform ESG integration techniques.

ESG Integration – Active Fundamental Strategies (1)

Fundamental analysis

- Macroeconomic & industry analysis
- Assessment of company fundamentals
- Financial reporting & ratio analysis
- ESG factor materiality assessment

Forecasting & Valuation

- Forecasting & financial modelling
- Scenario analysis
- Valuation models (absolute/relative)

Stewardship activities

Portfolio construction

- Sector & region/country weighting
- Position weighting

ESG Integration in Equity Analysis (2)

Income statement

- Adjust revenue or revenue growth rate
- Adjust operating costs or operating margin

Balance sheet

- Adjust asset impairment charges

Cash flow statement

- Adjust capital expenditure

Valuation

- Adjust the discount rate
- Decrease / increase / exclude the terminal value

Examples

Reflect reputational impact on revenues.
Adjust future sales levels for future work stoppages (accidents/flooding) or suspension of sales due to environmental reg's (certain products banned)

Increase operating costs to account for newer, more costly production processes to comply with new social and environmental regulations (i.e. anti-pollution).

Apply balance sheet impairment charges to reduce ("write down") the book value of a mines or raw material deposits to reflect reduced earnings.

For example, increase capital expenditure for construction of desalination plants or roll-out of zero carbon production equipment.

ESG Integration in Listed Equity: Drivers & Barriers

Key Drivers

- Risk management
- Client demand
- Regulation
- Alpha generation
- Fiduciary duty

Key Barriers (commonly cited issues & challenges)

- Low client demand
- No evidence of investment benefits of ESG
- Lack of historical and comparable ESG data
- Lack of company culture
- Too much non-material information being disclosed
- Limited understanding of ESG issues/ESG integration
- Limited amount of research
- Concerns about negative returns, tracking error, and underperforming the benchmark

Passive Equity Investing – Index Design

Select investment universe

Construct new index

or

Identify a parent index

Design index methodology

- Input data types & sources
- Filters and selection criteria
- Weighting rules and constraints

Stewardship activities

Index construction

- Launch & maintain
- Regular reviews and updates

PRI Resources for Listed Equity Investors

What PRI Provides for Listed Equity Investors (1)

Visit https://www.unpri.org/investment-tools/listed-equity

Listed Equity Snapshot

- Explores the state of the approaches to incorporating ESG, active ownership and proxy voting in listed equites.
- Explores current practices among our global signatory base.
- Data can be shown on per-region basis.
- Based on key elements of data from PRI's annual signatory reporting

Introductory & Technical Guides

- Responsible investment, explaining the approaches to:
  - Considering ESG issues when building a portfolio – Integration – Screening – Thematic and explains the investment approaches in Fundamental Analysis, Quant and Smart Beta and in Index Investing
  - Improving investees' ESG performance – Engagement & Proxy Voting
- Screening – explaining the different types of screening and implications for portfolio characteristics
- ESG & passive investment strategies

What PRI Provides for Listed Equity Investors (2)

Visit https://www.unpri.org/investment-tools/listed-equity

Guidance and Case Studies

- Practical examples of ESG incorporation in the investment process provided by signatories

Podcast & blog series

- Recently launched series of podcasts focusing on the topic of "Leadership" in the listed equity space.
  - Episode 1 with Alex van der Velden, Ownership Capital.
  - Episode 2 with Peter Michaelis, Liontrust AM
  - Episode 3 with Edris Boey, Maitri Asset Management
  - Episode 4 with Steve Lydenberg, Domini Social Investments

PRI & Academic Blogs

- ESG factors and equity returns – a review of recent industry research
- Highlights of the signatory survey on passive strategies and ESG
- ESG in listed equity – evolution or revolution?
- The evolution of screening: from 'sin' to sophistication

Thank You… Interested to Learn More?

- **Visit [Become a Signatory]**
- **Explore range of publicly available resources via [PRI website]**
- **View [PRI Events & Webinars] via BrightTALK**
- **Listen to [PRI Podcasts] & read [PRI Blogs]**

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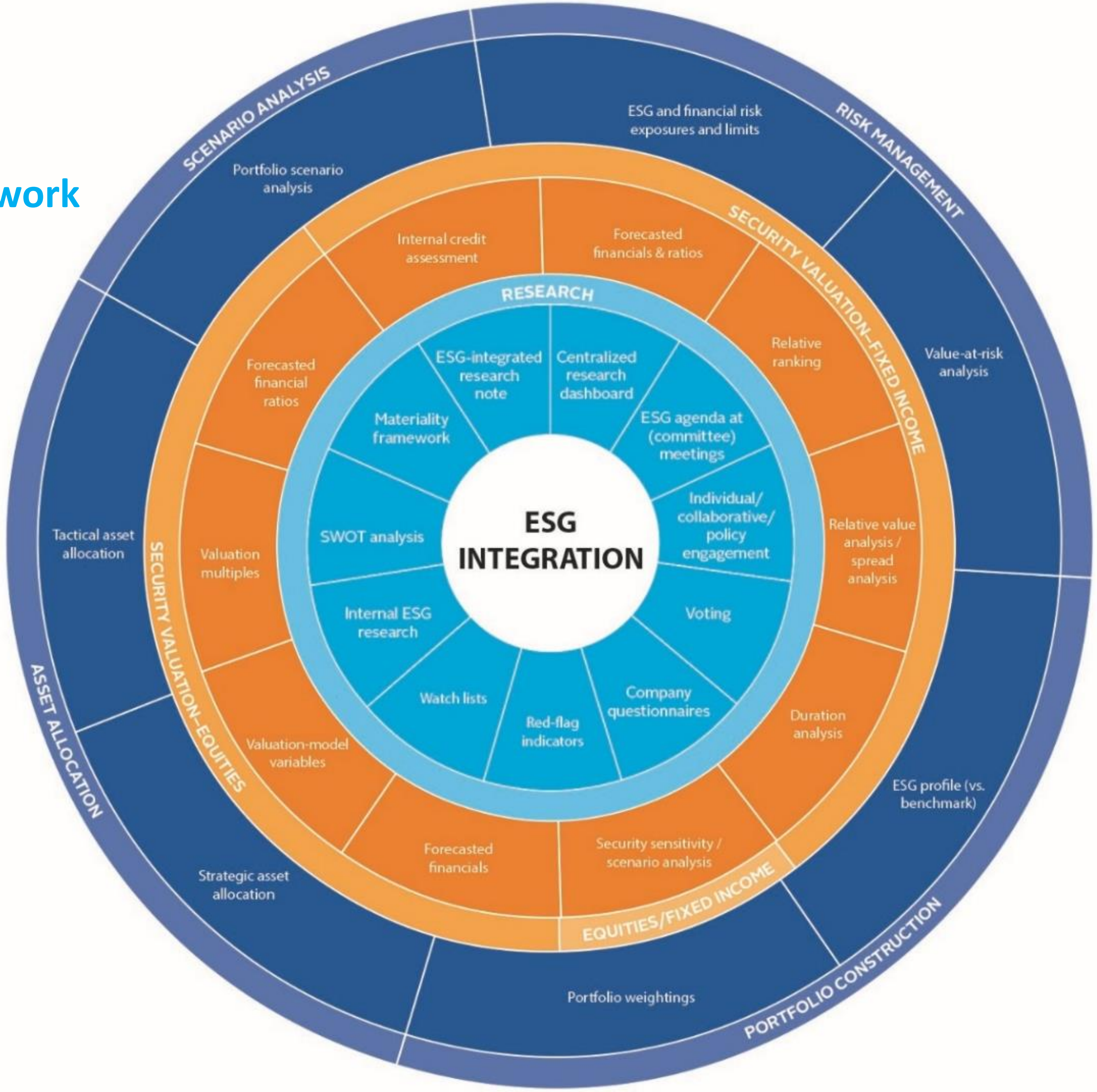
Appendix: Additional Listed Equity Slides

PRI & CFA Institute:
ESG Integration Framework



Comparing Key Characteristics of ESG Incorporation Approaches

ESG incorporation in listed equity across the active-to-passive spectrum

ACTIVE → PASSIVE

INCORPORATION APPROACH	INVESTMENT APPROACH		
	FUNDAMENTAL ANALYSIS	**QUANT AND SMART BETA**	**INDEX INVESTING**
Integration	ESG factors are integrated into absolute and relative valuation models alongside all other material factors. Investors can adjust forecasted financials (such as revenue, operating cost, asset book value and capital expenditure) or company valuation models (including the dividend discount model, the discounted cash flow model and adjusted present value model) for the expected impact of ESG factors.	ESG factors can be integrated into quantitative models alongside factors such as value, quality, size, momentum, growth and volatility. ESG factors and scores can be used as a weight in smart beta portfolio construction to contribute to excess risk-adjusted returns, reduce downside risk and/or enhance portfolios' ESG risk profile.	Material ESG issues are identified and translated into rules that feed into portfolio construction, alongside traditional factors. The overall ESG risk profile, or exposure to a particular ESG factor, can be reduced by adjusting index constituent weights or by tracking an index that already does so.
Screening	Filters are applied to lists of potential investments, ruling companies in or out of contention for investment based on an investor's preferences, values or ethics. Filters are typically based on including or excluding particular products, services or corporate practices.		
Thematic	Companies that meet valuation and financial thresholds – and address sustainability challenges and themes – are identified for investment. Includes impact investing.		Indices that focus entirely on environmental and social themes – such as clean technology, climate change, microfinance – are selected for investment.

Incorporating RI Capacity into Firm Structure

Integrated Investment team:

Portfolio managers and investment analysts conduct the ESG analysis and integrate it into overall investment analysis and decisions.

Pros	Cons
ESG factors and traditional factors are included within the portfolio manager's research.	Portfolio managers may not have time to conduct ESG research.
ESG issues are included in discussions.	Portfolio managers may not be sufficiently familiar with ESG issues and trends.
Engagement activities will include portfolio managers.	Portfolio managers may not have time to engage with companies.

Dedicated ESG team & Investment team:

An ESG team conducts the ESG analysis, which the investment teams integrate into overall investment analysis and decisions.

Pros	Cons
Comprehensive ESG research conducted on all investments in the portfolio.	Portfolio managers may not read the ESG analysis performed by the ESG team.
ESG team can liaise with managers for a more holistic approach to ESG analysis.	The ESG research may not be in a form can be integrated into valuation models.
Engagement activities on ESG issues will be performed.	Portfolio managers may not be aware of the engagement activities.