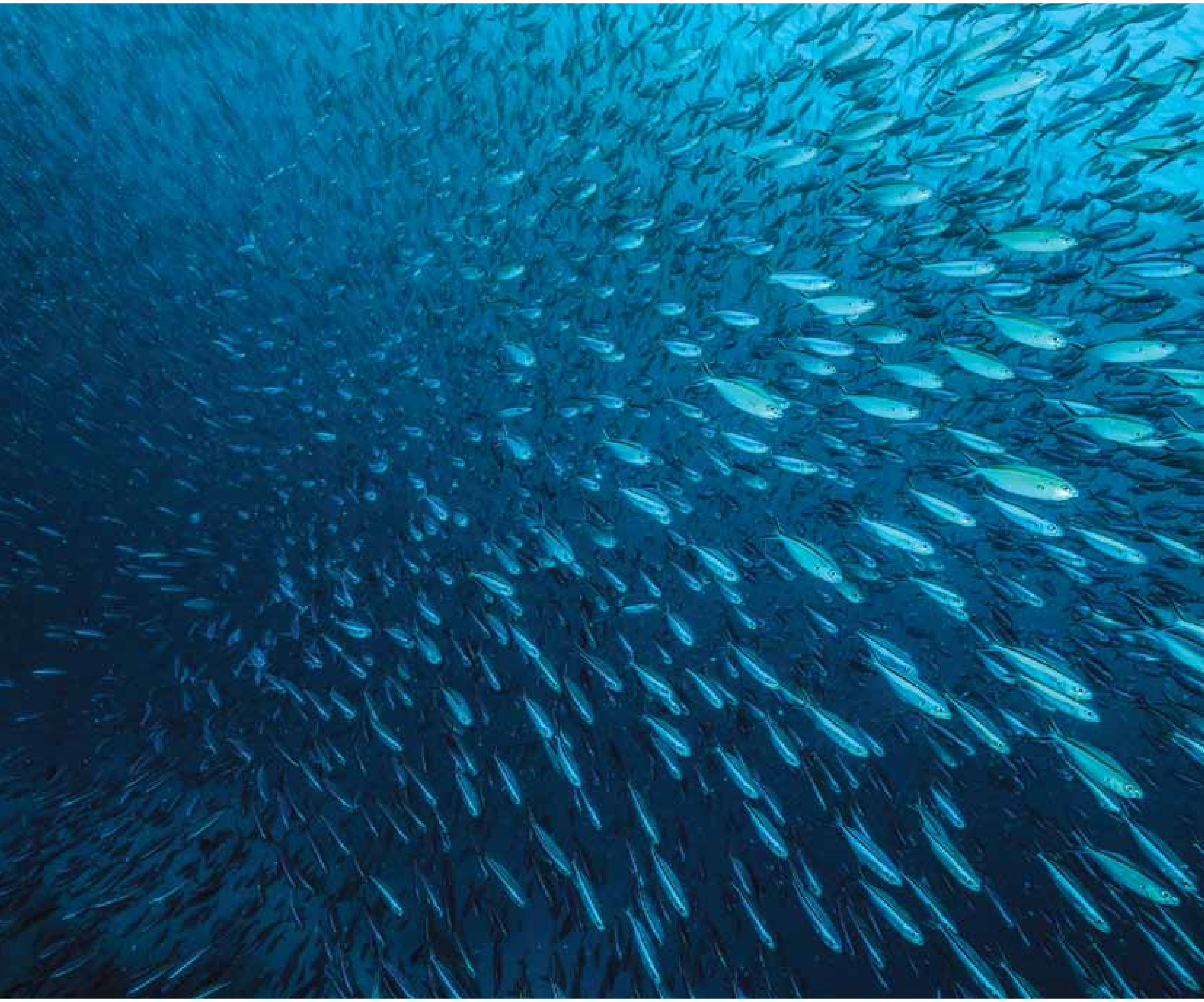
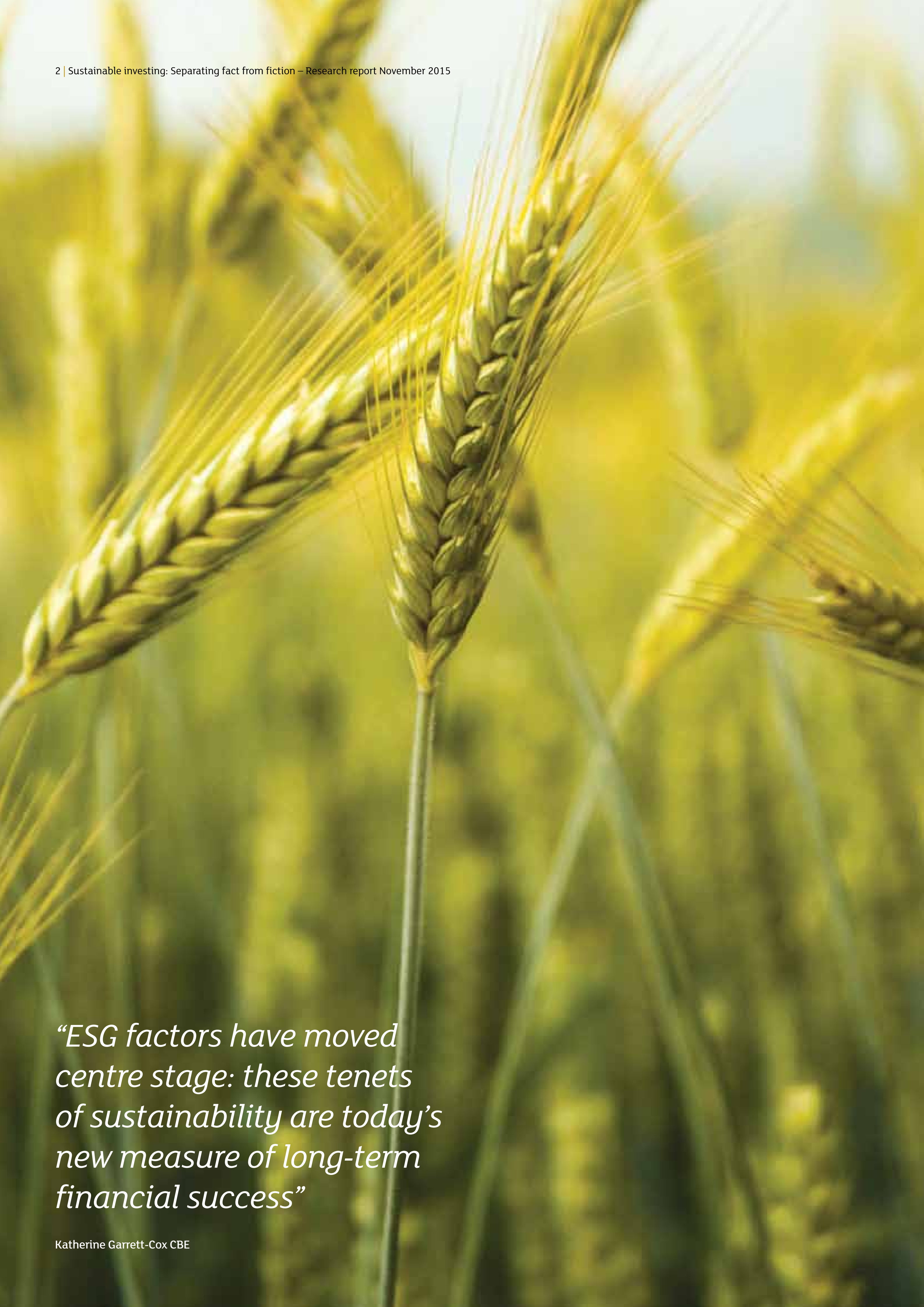
Research report – November 2015

Sustainable investing: Separating fact from fiction

Institutional investor attitudes to the role of Sustainable and ESG-based investing





“ESG factors have moved centre stage: these tenets of sustainability are today’s new measure of long-term financial success”

Katherine Garrett-Cox CBE

Foreword

Among the challenges facing the investment community reported at the World Economic Forum were economic growth, social inclusion, climate change and the ongoing impact of technology and globalisation. In a world of diminishing natural resources, an ageing population and geopolitical disruption, environmental, social and governance (ESG) factors have moved centre stage: these tenets of sustainability are today's new measure of long-term financial success.

Aligning ESG factors with investment strategy towards sustainable investment outcomes has never been more important and, as this research report confirms, there is no question that ESG considerations are moving to the forefront of investor agendas.

In addition to the impact of global influences on investment strategy, institutional investors face challenges closer to home, not least ongoing regulatory change, a demanding consumer-driven economy and a persistently low-yield environment. For UK pension funds, charities, foundations and endowments, fulfilling their fiduciary duty means meeting their liabilities and generating the investment growth in order to do so, taking the long-term view that is widely acknowledged to be in the best interests of their beneficiaries.

In this research, as has been borne out by wider studies, institutional investors which embrace responsible principles and invest in sustainable companies not only feel better equipped to achieve diversification, but also have a less volatile portfolio, and are thus able to manage risk more effectively. Companies that adhere to standards set by governments and other bodies are less vulnerable to sudden regulatory or economic shocks and offer the potential for more stable, predictable returns over the long term.

It also makes financial sense to invest in companies which are developing the technologies and infrastructure that will support a more prosperous and resilient future. These companies are much more likely to thrive, and consequently represent better investments for institutional investors and, ultimately, their beneficiaries.

Alliance Trust Investments is part of a growing group of institutions around the world championing the importance of ESG integration; separating the facts from the fiction surrounding sustainable investing is a necessary part of this process. Alongside an increasing number of asset managers, we are committed to supporting the UN Principles for Responsible Investment, not just because we believe it provides the right framework for good business conduct, but because the evidence is clear: companies with robust sustainable practices demonstrate better operational performance, which then translates into cashflows and has a positive influence on investment performance.

Fundamentally, we are an active asset manager, committed to providing the solutions that help investors minimise risk, create value and meet their liabilities through a process that is relevant, resilient and responsible.

Katherine Garrett-Cox CBE
Chief Executive, Alliance Trust Investments

"Institutional investors acting in the best interest of their clients should consider the environmental and social impact of companies' activities and associated risks among a range of factors which might impact on the performance of a company, or the wider interests of savers, in the long term."[1]

John Kay

ALMOST

300 Asset Owners

900 Asset Managers

have signed the UNPRI to incorporate ESG into investment analysis and decision-making[2]

€7.1 trillion of assets are managed in strategies integrating ESG in investments[3]

80%

of global CEOs view sustainability as a route to competitive advantage[4]

"The biggest challenge is a perception among a lot of senior investment people, particularly on boards and committees, that by thinking about anything but short-term financial returns you are going to be in breach of your fiduciary duty."

Jane Ambachtsheer, Partner, Chair – Responsible Investment, Mercer

1 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

2 UN PRI http://www.unpri.org/about-pri/the-six-principles/" \l "sthash.xO8kwxQe.dpuf" http://www.unpri.org/about-pri/the-six-principles/#sthash.xO8kwxQe.dpuf

3 Eurosif, 2014, http://www.eurosif.org/our-work/research/sri/european-sri-study-2014/

4 Accenture, 2013, https://acnprod.accenture.com/~/media/Accenture/Conversion-Assets/DotCom/Documents/Global/PDF/Strategy_5/Accenture-UN-Global-Compact-Acn-CEO-Study-Sustainability-2013.pdf

Contents

Executive summary

The global sustainable investment market increased by 61 per cent between 2012 and 2014 to reach USD21.4 trillion across all asset classes, from public equities and fixed income to hedge funds, microfinance and impact investments[5].

- According to the Global Sustainable Investment Alliance[6] (GSIA), Europe is leading the way with almost two thirds of the identified global sustainable investment assets and the vast majority of the remainder concentrated in North America. Together, Europe, the United States and Canada account for 99 per cent of global sustainable investing assets.
- The GSIA defines sustainable investing, also known as responsible investing, as an investment approach that considers environmental, social and governance (ESG) factors in portfolio selection and management. Numerous meta-studies and papers conclude[7] that there is a positive correlation between sustainability and corporate financial performance.
- Our research among UK institutional investors and their consultants confirms this view: of the three ESG factors, the key driver in investment decision-making is governance, with four out of five respondents (80%) citing this as their primary consideration in executing their investment strategy.
- Pension scheme trustees in our research were clear about their fiduciary duty to deliver against their investment objectives, but some expressed a conflict of interest between the short-term reporting demands expected of them and the long-term view that they acknowledged was in the best interest of the fund, and in turn their members. Sustainable investing was perceived as a long-term strategy.
- Pension consultants and industry experts responding to this research suggested that pension plans and defined contribution (DC) schemes in particular, with their long time horizons, are well placed to align ESG factors in their investment strategy. "As long-term investors, they need to be conscious of the sustainability of their investments over an appropriate time horizon. The pension fund assets can play an important role in shaping the future society that members will face, and thus, the real value of their retirement income."[8]
- Our research found a disconnect between corporate social responsibility (CSR) policy and business and investment strategy. One of the biggest criticisms was that CSR principles are used for little more than marketing purposes. Corporate sponsors and pension schemes operate as separate entities and there is considerable scope for them to cooperate more closely towards more holistic solutions for their members.
- Shareholder voting, stewardship and engagement were perceived as increasing in importance, both for SRI investors and others. In our research, respondents also reported a growing awareness of Impact investing, particularly those who belonged to large-scale pension funds.
- Nonetheless, it is a slowly-evolving trend and despite evidence from institutions such as the World Economic Forum that investors have great influence over the social, environmental and economic challenges of societies, they continue to operate within a market infrastructure and investment ecosystem where the incentives do not generally balance social, environmental and economic impact.
- Social impact investing has been lauded as an emerging investment approach which could help to reconcile shortcomings in traditional financial markets. The younger generation, strong proponents of social media and the transparency that comes with it, and who some would argue are more environmentally and socially conscious, were reported by respondents as being likely to grow in influence; auto-enrolment has resulted in a new body of savers and investors to the markets who are expected, over time, to want more say in how their money is invested.
- After a decade or more of peer-reviewed research there is a substantial body of evidence to demonstrate that values-based investing can produce very competitive performance and long-term risk reduction compared with non values-based alternatives.

5 Global Sustainable Investment Alliance

6 Global Sustainable Investment Alliance (GSIA): a group that comprises the seven largest sustainable investment membership organisations in the world, including the UK Sustainable Investment and Finance Association (UKSIF) and its European equivalent Eurosif

7 See page 24

8 NAPF, Corporates and their pension schemes: helping each other be more sustainable, 9 February, 2015

Sustainability and pensions: 'The long and the short'

In the current low rate and low growth environment, the challenges facing defined benefit schemes are particularly daunting. Today's investment imperatives are strategies that will help pension funds regain and maintain a path towards a stable and sustainable future.

In our research, sustainable investing was perceived as a long-term strategy and within the UK defined benefit (DB) landscape where, for the first time, private sector DB pension scheme liabilities are greater than those of the UK economy[9]; DB schemes are being advised by certain consultants to focus on de-risking growth solutions in order to achieve equity-like returns, but with less volatility.

The challenge is how to develop the solutions that will both plug the funding gap and help schemes meet their long-term liabilities. Pension consultants in our research acknowledged the importance of a sustainable asset management approach: with the right risk budget in place, a pension scheme can chart a course towards a lower risk future, avoiding, for example, interest rate risk and creating an opportunity to take 'rewarded risk' such as exposure to equities. These decisions stem ultimately from investment fundamentals: to achieve a low risk, low volatility portfolio that creates a stable base for risk management.

The pension scheme trustees who participated in our research were clear about their fiduciary duty to deliver against their investment objectives, but some expressed a conflict of interest between short-term reporting demands and long-term investment goals. The constraints of so called 'quarterly capitalism' are well understood to be counter-productive, but are nonetheless difficult to overcome.

Tim Currell, Head of AON Hewitt's Sustainable Investment & Corporate Governance team says, "One of the main inhibitors to investing in certain sustainable investments is that pension schemes are typically on a de-risking trajectory and so their allocation to growth assets is reducing in importance. Trustees are focusing much less on equities and property; their attention is focused more and more on the liability side. Also, most trustees have limited time to spend on investment issues and so they rely very heavily on their third party asset managers. They assume that the asset managers are getting on with what's expected of them. Also, I don't think asset managers are challenged enough about what they are delivering in terms of sustainable investments, and trustees don't have the time or the depth of understanding of the issues to be able to challenge the fund managers enough."

The view of another pension consultant is also typical of our findings: "I genuinely believe that over the longer term companies with proven ESG credentials will do better, but people are still focused far too much on the short term. Most funds report monthly or quarterly performance numbers and are looking at what's been achieved against the benchmark over the last three months. People need to be re-educated to take a longer term approach. With our pension clients, even though the bare minimum is for us to report annually, the reality is that we produce formal valuations every six months with performance figures."

9 Hymans Robertson, June 2015: UK private sector DB schemes collectively have liabilities of over £2 trillion, far in excess of the UK's GDP of £1.8 trillion

"Our members are clear that their fiduciary duty to their members and beneficiaries does not prevent them considering ESG matters. That said, it is right that theory and reality do come into tension with triennial valuations and annual performance reporting."

Will Pomroy, Policy Lead: Corporate Governance & Stewardship NAPF

Will Pomroy, National Association of Pension Funds (NAPF) Policy Lead: Corporate Governance & Stewardship, says, "Our members are clear that their fiduciary duty to their members and beneficiaries does not prevent them considering ESG matters. That said, it is right that theory and reality do come into tension with triennial valuations and annual performance reporting.

Many companies have spent great effort understanding the risks to their business models and communicating to a growing pool of investors their long-term investment case. Equally, investors have devoted more resources to analysing and engaging with investee companies. At the nexus of these two strands sits pension schemes. Whilst there are obvious conflicts to manage on both sides, there is also clearly scope for a more synergetic relationship between pension schemes and their sponsors – in particular within a DC world. Both undoubtedly have lessons for the other to the benefit of both parties and ultimately the scheme members – many of whom will also be employees of the company in question."

The call for a longer-term view (in line with the findings of the Kay Review) and the abolition of short-term reporting demands (like mark to market accounting) appears to be widespread within the investment industry, and yet action lags behind good intention.

"There is a big gap between the rhetoric of ESG investing and its reality, are direct investments in ESG funds" says Professor Amin Rajan, CEO, CREATE-Research. "There are many such funds out there that remain sub-scale, notwithstanding investors' reported interest in them. Sharia funds are a case in point. The key reason is their emphasis on long-term returns at a time when investors have been forced to become short termist in their approach by unconventional monetary policies of central banks worldwide. These have pushed investors of all hues up the risk curve and lifted valuations of all assets – good, bad and ugly. The resulting convictionless trades have left investors' fingers on the 'sell trigger' constantly. The distinction between value investing and value traps has blurred significantly. ESG investing is an unwitting casualty."

At the very least, demands for reporting of long-term strategies and investment principles should be made more meaningful.

Camilla de Ste Croix, Senior Policy Adviser for ShareAction says, "We believe that structural issues, in particular misaligned incentives, need to be tackled, as the Kay Review identified. There is also a growing debate around outsourcing and whether investors with long-term liabilities, like pension funds will ever be able to behave like true long-term investors unless they bring investment back in house, or at least have enough internal resource to set and monitor long-term investment beliefs and strategies. Otherwise it's difficult to overcome the short-term focus that short-term mandates and time frames for evaluating performance imply."

Could a new impetus to bring about positive change come from DC scheme governance and a younger generation of investors?

DC schemes, with their long time horizons, are well placed to align ESG factors with their investment strategy

The process of auto enrolment in the UK is well underway and has introduced many millions of employees into pension savings for the first time. Pension consultants responding to this research suggested that DC schemes, with their long time horizons, are well placed to align ESG factors with their investment strategy. As long-term investors, it is important that they recognise the sustainability of their investments over the relevant time horizon. They also recognised that there are significant opportunities for firms to better align their stated corporate purpose with their pension offering to employees.

Jane Ambachtsheer, Partner, Chair – Responsible Investment, Mercer, agrees but says "In many regions DC schemes don't seem to have the same governance oversight, and in reality much is often delegated to third party implementers. Therefore, I've seen very little evidence of DC schemes (to date), taking this approach. I think it is an opportunity, but there are some obstacles to 'connecting the dots' in practice. More member engagement would be a great catalyst, but individuals are often quite disengaged from their pension schemes."

Tim Currell, Head of AON Hewitt's Sustainable Investment & Corporate Governance team says, "You could argue that it is DC investors we ought to be focusing on because these investors are going to have equities and growth assets in their mix for thirty, forty, fifty years; it is much more relevant for them."

Camilla de Ste Croix, Senior Policy Adviser for ShareAction adds, "The profile of the many millions of workers who are becoming part of the investment system via auto-enrolment is different from that of traditional investors, and this should necessitate a rethink of what is in their best interests. For example, many

10 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

of these new savers are on low incomes so it is in their broad interests for the people investing their savings to engage with investee companies around issues of pay inequality and living wages. We believe that as the pension pots of auto-enrolees grow, they will start to be more interested in where and how this money is invested. We have heard anecdotally this is the case in Australia, which adopted compulsory pensions some years before we and where people talk about their 'super' in the pub.

Also, although many savers find the jargon of the investment industry off putting, it doesn't mean that they are not interested in, or qualified to comment on key responsible investment issues, like climate change, executive pay, and human rights abuses in supply chains. Several recent opinion polls from NAPF, UKSIF's Ownership Day and Eurobarometer showed that savers do care about the ethical dimension of how their money is invested and don't want investors to chase returns at the expense of considering impacts on the environment, society or good governance and behaviour of corporates."

Pension funds are powerful asset owners with the potential to exert great influence on the future society their members will inhabit, and consequently, shape the real value of their retirement income.

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Embedding sustainability: what's holding pension funds back?

In its 2013 survey of the responsible investment performance of UK Pension Funds, ShareAction[11] reported, "With great power comes great responsibility but not, it seems, when responsible investment is concerned. The top 10 occupational pension schemes in the UK hold over £203bn in assets, but our rankings[12] show that there's still huge room for improvement in the responsible investment performance of these powerful investors."

The survey revealed that newer pension providers are more willing to be transparent and accountable to the savers they serve than long-established occupational pension schemes. Showing members that their scheme is working to protect their savings, while addressing issues they care about, be they social, environmental or governance concerns, can create more engagement between the dry, potentially off-putting world of investment and the real world economy.

"Responsible investment encompasses more than just screening out companies that are ethically questionable"

Camilla de Ste Croix, Senior Policy Officer, ShareAction

Camilla de Ste Croix, Senior Policy Officer at ShareAction says, "Savers should have the right to know if their money is funding the arms trade or the tobacco industry, but responsible investment encompasses more than just screening out companies that are ethically questionable. A responsible fund manager will engage in a dialogue with investee companies, exercise shareholder voting rights and then explain how and why they voted to the people whose pension savings are at stake."

In our research, findings were polarised between respondents for whom ESG integration is a natural part of their investment strategy and those for whom it plays a minor role, or who did not feel sufficiently well informed to 'take a stance'.

Among the examples of exemplary commitment to ESG integration and sustainable investing are those of The Environment Agency Pension Fund and The Crown Estate.

The Environment Agency Pension Fund

"We're driven by fiduciary duty which we've defined to be fulfilling our members' long-term interest. We believe that the only way to be able to do that is to factor in environmental, social and governance issues. A component part of delivering that responsible investment strategy is a strong commitment to sustainable investments, as a very large component part of our strategy overall; investments which are driven with the objective of delivering financial goals, but also in a very sustainable way, so they're also contributing positively in some shape or form, whether that be to social outcomes, environmental outcomes or a combination of the two." *EAPF*

The Crown Estate

"Our 2022 vision is to be a progressive commercial business creating significant value beyond financial return and to make a positive impact through our Total Contribution to the UK. We have identified six strategic objectives to help us deliver this and 12 material issues, key factors which could affect our ability to deliver. Total Contribution is the methodology we use to measure and communicate our environmental, social and economic impact. By measuring these impacts we can show that we are managing our material issues and adding value to our business and society. Monetising these values is a further step in the best practice of integrated reporting and thinking."[13]

Professor Amin Rajan, CEO, CREATE-Research says "I believe that there is far more implicit ESG investing now in progress than is commonly recognised. Although the demand for overt ESG funds has fallen short of expectations, ESG screening is now embedded in the investment processes of a large number of asset managers. Issues like labour practices, carbon footprint, corporate governance and community involvement are used in the initial screening process. Additionally, large pension investors are also being obliged to factor ESG into their investment choices – directly or indirectly.

They may not be buying ESG funds, but they are certainly embedding the same ethos in their choice of companies in which they invest. These are baby steps but the world of investing has never been noted for giant leaps."

11 http://shareaction.org/
12 Entrusted with our future: A survey of Responsible Investment Performance of UK Pension Funds, 2013
13 http://www.thecrownestate.co.uk/

What drives the stance on sustainable investing? Which ESG factors have the most traction?

The criteria for selecting the kind of companies or funds that will deliver sustainable returns are dependent on a wide range of factors. In our research, negative screening was typically the starting point for the majority of respondents, screening against companies involved in the arms trade, for example, gambling and payday loans.

Environmental

Companies in certain sectors, such as construction, manufacturing and energy, can make a ready connection with environmental factors and respondents reported a willingness to do this, particularly at a local or regional level, where the impact is close to home and the benefits readily understood. Global resource shortage and climate change were reported by some as so beyond their sphere of influence that they were less motivating as a result.

"Everyone is aware now of environmental issues but there is little that we can do, it is something with which the bigger companies should get involved." *Pension Fund Trustee*

Social

Social factors were reported as being more emotive and subjective. Some respondents found it more difficult to objectify and rationalise investment decisions in relation to these:

"It is more nebulous, so it is harder to pin down. One company's definition might differ to another. I think an easier way to verify the progress the companies are making is in their governance criteria." *Pension Consultant*

Governance

Governance was considered of prime importance and also implicit in decisions regarding the choice of investment partners.

"We fully expect tight governance controls to ensure that there would not be any destruction of wealth through speculation or use of derivative instruments. Similarly, we would expect asset managers to perform due diligence to ensure that the organisations in which they invest are operating socially responsibly. In the long term, if you ensure that investments are being run responsibly then you should also be safeguarding the wealth that is being invested in them." *Pension Fund Trustee*

"I expect fund managers to invest in companies with proper governance – that is certainly how we manage them – proper boards, reporting, lines of communication, transparency and so on." *Pension Fund Trustee*

Will Pomroy, NAPF Policy Lead: Corporate Governance & Stewardship says, "It is certainly true that there is both a more developed understanding of what is corporate governance best practice and breadth of academic evidence to demonstrate the link between high standards of corporate governance and performance. Whilst high standards of corporate governance can be considered to be relevant to all companies, the materiality of different environmental and social factors can vary across sectors."

Defining today's ESG factors: Environmental

- Air quality output
- Biodiversity impacts
- Carbon footprint
- Climate change resilience
- Energy consumption
- Environmental policy
- Fresh water use
- Ground water depletion
- Impacts on the cryosphere
- Impacts on the food supply
- Land use
- Natural resource management
- Ocean productivity and acidification
- Regulatory and legal risks
- Supply chain management
- Vulnerability to extreme weather
- Waste and hazards

Defining today's ESG factors: Social

- Access and affordability of product or service
- Consumer rights
- Corporate philanthropy
- Customer relations
- Data security and customer privacy
- Diversity issues
- Employee engagement
- Fair disclosure and labelling
- Health and safety of communities
- Human capital management
- Human rights
- Labour relations
- Product quality and safety
- Responsible R&D
- Stakeholder and community relations
- Supply chain management

Defining today's ESG factors: Governance

- Accounting and audit process
- Board composition
- Business ethics
- Compliance
- Executive remuneration
- Lobbying and political contributions
- Ownership structure
- Reporting and disclosure
- Shareholder rights
- Succession planning
- Transparency
- Voting procedures

Additional considerations for funds…

- Advisory committee powers and composition
- Client alignment and fee structure
- Fund governance

The CSR ESG credibility gap

Organisations that extol the virtues of their corporate social responsibility do not necessarily extend these principles to their pension schemes or their investment strategies. Our research found a high level of polarisation between those which do and those which do not integrate CSR with ESG factors, and in turn their investment strategies.

Those with an integrated approach in this regard can lay claim to a number of advantages, from better talent recruitment, through to better access to capital. In a study[14] on this topic (whether superior performance on corporate social responsibility strategies leads to better access to finance) the authors found that better access to finance can be attributed to a) reduced agency costs due to enhanced stakeholder engagement and b) reduced informational asymmetry due to increased transparency.

One of the biggest criticisms is that CSR principles have been used for little more than marketing purposes. "CSR is an old-fashioned idea that needs to be upgraded," says Eric Orts, Professor of Legal Studies and Business Ethics at Wharton, and Director of the school's Initiative for Global Environmental Leadership. "For companies to take CSR seriously, it has to be integrated into the DNA of the enterprise."

Negative screening against investments that will bring negative publicity or other potential reputational damage is a starting point, but has evolved to encompass much more sophisticated measures of appropriateness and suitability.

Pension scheme trustees and managers in our research reported on the structural, governance 'disconnect' that meant CSR and ESG are not always aligned because the corporate sponsor and pension scheme operate as separate entities, although they believed that ESG factors and corporate policy will evolve to encompass both the company and the scheme, in time: "I think it's inevitable that the two will start to move together but they are distinct entities and we are set up so that we are independent. We always check company policy whenever we're looking into new areas, and we're always looking to comply with company policy, but we can deviate from it." *Pension Fund Trustee*

Will Pomroy, NAPF Policy Lead: Corporate Governance & Stewardship says, "From an investor's perspective a company's CSR policy is only of interest if it is clearly linked to the business strategy."

Camilla de Ste Croix, Senior Policy Adviser at ShareAction says, "ShareAction has in the past helped bring the CSR departments and pension funds of large corporates together, so that the pension fund can benefit from the expertise of their colleagues in CSR, and believe this is an effective way to drive up RI within corporate pension funds. Even though legally speaking the company and the pension fund are separate, they may well operate from the same company HQ. We hope that CSR and reputational risk, as a motivation for improving company performance, will evolve so that scrutiny is also placed on the pension scheme and they can benefit from best practices.. For example, if a company has publicly committed to using only sustainable palm oil in its supply chain, its pension fund should engage with or divest from unsustainable palm oil producers."

Camilla adds, "We have seen a similar process take place with charities which face reputational risks if they invest funds in a way that is perceived to contradict their mission and values. Examples of this include the Church of England and Wonga, or the Panorama exposé of Comic Relief's investment."

14 Corporate social responsibility and access to finance, Strategic Management Journal, Volume 35, Issue 1, pages 1-23, January 2014.

Charities: aligning values with investment objectives

In the charity sector, negative screening – cancer charities avoiding tobacco stocks, alcohol abuse charities not investing in drinks companies – has moved into what some have termed mission related investing.

Mission-related investing ranges from an environmental organisation investing in renewable technology, to endowed foundations lending money to Charity Bank where they expect a return, but also see their money being used for charitable ends. The Church Commissioners, for example, recently revised its investment policy to exclude payday lenders and pawnbrokers, and also plans to challenge its internet provider investments that promote pornography.

While some have embraced sustainable, responsible and mission investing as a means of meeting investment and charitable objectives, others keep their mission and returns separate. The two, of course, are not mutually exclusive.

"The Church Commissioners' ambition is to be at the forefront of responsible investment; [it]...aims for the best return from their assets to help sustain the nationwide ministry of the Church, without undue risk and in line with their ethical investment policy. Their long term target is a return of at least RPI plus 5% over the long term."[15]

Some of the larger charities are leading the way in terms of embracing sustainability in all aspects of their investment choices and selection of investment partners:

Their philosophies and sustainability principles are publicly promoted on their websites and can be regarded as examples of best corporate (sustainable) practice.

For instance, the Church of England Pension Scheme adheres to the standards set by The Ethical Investment Advisory Group (EIAG), an over-arching body which supports the Church of England's national investing bodies on ethical investment: the Church Commissioners, the Church of England Pensions Board and the CBF Church of England funds managed by CCLA.

As a major investor, the EIAG takes an activist role in the companies in which it is invested, by, among other things:

- Advising the investing bodies on ethical investment policies
- Engaging with companies on ethical issues on behalf of the investing bodies
- Overseeing proxy voting at company general meetings on behalf of the Church Commissioners and the Church of England Pensions Board

The EIAG is a member of UK Sustainable Investment and Finance (UKSIF). The EIAG Secretariat supports the Church Commissioners and Church of England Pensions Board in their participation in the activities of the Church Investors Group, the United Nations Principles for Responsible Investment, the Institutional Investors Group on Climate Change and CDP (formerly the Carbon Disclosure Project).

Similarly, the Crown Estate has a 'through and through' philosophy of sustainable business practices, to the extent that the philosophy has become synonymous with its 'brand'; the leadership is confident that sustainability is good business and delivers good performance:

"We are a values-driven business investing in and managing some of the UK's most important assets, ensuring they are sustainably worked, developed and enjoyed to deliver the best value over the long term."[16]

15 https://www.churchofengland.org/about-us/structure/churchcommissioners/assets.aspx
16 http://www.thecrownestate.co.uk/media/476239/wales-highlights-2015.pdf

In our research, several respondents – including charities – were acutely aware of the dangers of the negative publicity they might face as a consequence of investing in areas that were either contrary to their CSR policy or mission, but with a few exceptions, did not feel as well-informed as they might be on how best to manage this process and were largely reliant upon their advisers. Consultants and asset managers concede that the process can be complex but that to simply avoid these issues, and rely on negative screening alone, is inadequate.

Peter Michaelis, Head of Equities at Alliance Trust Investments says, "In our experience, there are a growing number of investors looking for asset managers which are genuinely embedding sustainability into the way they manage investments but we recognise that it can be a daunting prospect. We would advise them to ask their asset managers the following questions:

- Describe the trades driven by ESG factors over the last year
- From a selection of stocks in the portfolio, what is their view of ESG for each one?
- Who does the ESG analysis and how is it linked to investment decisions?
- If CO_2 emissions become taxed, priced or regulated more stringently, what will happen to the portfolio?

The answers to these questions should enable them to assess whether or not they have a truly integrated investment approach to sustainability, or whether it is little more than a veneer."

The Charity Commission's guidelines on ESG risk[18]

When considering which companies and organisations in which to invest, charities are increasingly taking into account such factors as impact on climate, employment practices, sustainability, human rights, community impact, executive compensation and board accountability. These are all examples of ESG risk areas which can have long-term impacts and can affect the value of a company's shares positively or negatively depending on how the risk areas are managed.

Trustees can:

- decide on the importance and extent of ESG criteria in their investment policy
- look at the reputational risk to the charity that might arise from their ESG policy (or lack of one)
- make sure that any investment manager they use is aware of and willing to act in accordance with their ESG policy
- recognise that the extent to which a company manages ESG risk may have an effect on the returns that it can offer and its long-term viability
- look at whether a company discloses its ESG risk management processes and how it verifies that disclosure

"As a consultant who has worked in the charity sector for many years, historically the focus has been on negative screening; but we are doing the education to help charities understand that by implementing ESG into the investment process there can be positive outcomes without strict screening out. This is an educational work in progress."

Investment Consultant, Charity and Not-for-Profit sector

17 http://www.thecrownestate.co.uk/

18 http://webarchive.nationalarchives.gov.uk/+/http://www.charitycommission.gov.uk/detailed-guidance/money-and-accounts/charities-and-investment-matters-a-guide-for-trustees-cc14#a2

Stewardship, engagement, impact investing and the role of asset managers

The Financial Reporting Council has seen a significant increase in signatories to the UK Corporate Governance Code with full compliance by the FTSE 350 reported as 61.2% and 93.5% complying with all but 1 or 2 provisions. However, it is concerned that there is much more to do.

"Being 'active owners' is not about 'going greener' but about achieving better outcomes for members"

Will Pomroy, Policy Lead: Corporate Governance & Stewardship, NAPF

The Financial Reporting Council (FRC) recently expressed concerns about the role of proxy advisors, particularly in terms of a perceived lack of engagement with companies and a box-ticking approach by them and investors. A great many pension schemes, as responsible asset owners, are reliant on their asset managers to comply with the code as they simply do not have the resources to take the lead, and are being urged by the FRC to challenge asset managers to follow best practice: "Changing culture is not an easy task. Our recent guidance on risk management highlighted the need for boards to think hard about how they can better assess whether the culture practised within the company is the same as that which they espouse, particularly under pressure."

Stewardship and corporate governance lead for the NAPF, Will Pomfroy, says: "It doesn't take a great deal of digging to see that some managers are more committed to the code than others. This makes it very difficult for a scheme to try to compare and contrast different approaches to award mandates to those doing well."

He suggested that more asset owner signatories to the UK Stewardship Code would encourage behavioural changes leading to better stewardship by asset managers and companies but underlined the fact that: "For pension funds, being 'active owners' is not about them 'going greener' but about achieving better outcomes for members."

As this research illustrates, and has been covered earlier in the report, institutional investors are reliant upon their advisers to varying degrees, but all respondents agreed that consultants and asset managers should "earn their crust"… "they should be helping you [institutional investors] look through your portfolio. If you care enough about ESG principles and want them to manage these risks on your behalf, make it matter in manager selection and choose the managers who give you credible answers and credible responses to how they're managing these risks on your behalf."

While pension schemes expect asset managers to meet ESG and the Stewardship Code's principles, they could and should hold them to account as with other outsourced activities. Large schemes are better able to do this than their smaller counterparts.

"We fully expect tight governance controls to ensure that there would not be any destruction of wealth through speculation in derivative instruments. Likewise, we would expect asset managers to perform levels of due diligence to ensure that the organisations that they invest in are operating socially responsibly, and anything that involves a high profile scandal with lots of media attention invariably leads to a dramatic fall in share price so, on that basis, in the long term, if you ensure that those investments are being run responsibly then you should be safeguarding some of the wealth that is being invested in those."
Pension Fund Trustee

Shareholders are stewards of assets and accountable to their beneficiaries for how they manage those assets.

Tim Currell, Head of AON Hewitt's Sustainable Investment & Corporate Governance team says,

"What works really well is for an asset manager that integrates a consideration of these factors into their thinking, because that gives them a much more holistic view of a company and therefore enables them to make better long-term decisions. Certainly, in our research of asset managers, that is something that we look for. When we are talking to our clients or when we are presenting our research to our clients we comment on the extent to which the manager integrates these kinds of features into their decision-making process."

Engagement and voting

The Eurosif 2013 'Study Shareholder Stewardship: European ESG Engagement Practices' shows the extent to which shareholder stewardship is increasing in importance, both for sustainable investors and others. Eurosif reports the substantial growth of Engagement and Voting strategies, with a 36% increase per annum from 2011 to 2013 on a like-for-like basis to reach €3.3 trillion. The growth per annum since 2002 is 35%.

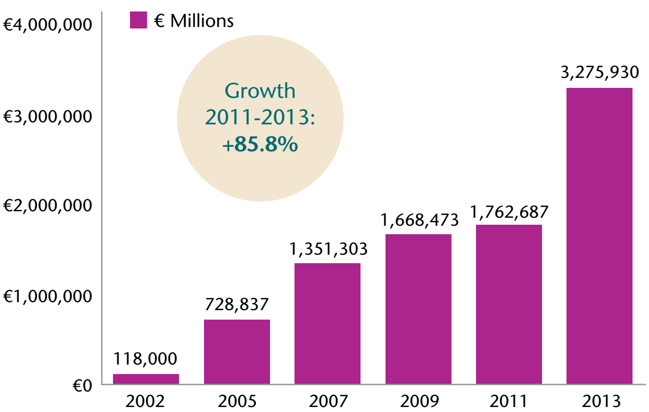
At a country level, the UK continues to be the main origin of this strategy, accounting for half of the European assets, followed by the Netherlands, another country with a strong tradition of active ownership.

Impact or social impact investing

Some market commentators have presented Impact investing as the next phase of sustainable investing and it has been shown as a new asset class by others, which Eurosif makes clear is "misleading." Its definition is that "Impact investing is an umbrella term that transcends several asset classes (e.g. fixed income, equity) and is another distinct way to channel funding to social organisations or enterprises that seek to tackle specific social challenges through market mechanisms. Alternative funding for these enterprises would come from philanthropy, public money and more recently, crowd funding. While grants (philanthropy) are not technically Impact investing (since there is no expectation of a financial return), they can, and do, play an important role for funding social enterprises, especially in their incubation and early development phase. What is clear is that Impact investors seek to generate both a financial return (to various extents) alongside a social one (social impact)."

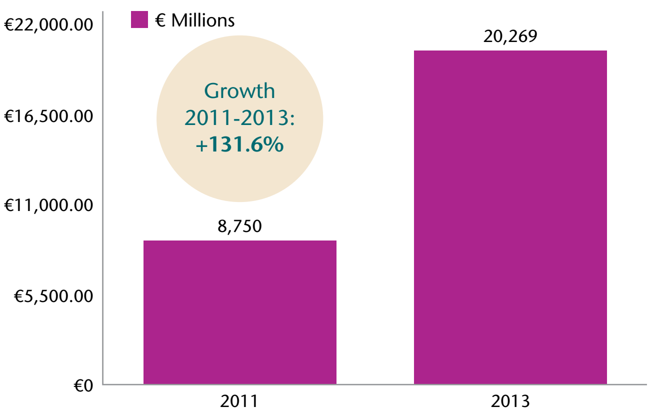
Will Pomroy, NAPF Policy Lead: Corporate Governance & Stewardship says, "In the UK, integration of ESG factors into mainstream investment analysis and stewardship are very much the dominant themes, interest in SRI as a separate asset class remains limited. For most pension funds Impact Investing remains outside their radar given their primary focus on maximising long-term risk-adjusted returns in order to meet their pension promises. However, where funds can demonstrate a strong investment

Growth of Engagement and Voting in Europe



Source: Eurosif

Growth of Impact Investing in Europe



Source: Eurosif

17 Eurosif is the not-for-profit pan-European sustainable and responsible investment (SRI) membership organisation whose mission is to promote sustainability through European financial markets

track record alongside a positive social impact then these will undoubtedly be of greater interest to larger schemes."

In our research, respondents reported a growing awareness of Impact Investing, particularly those who belonged to large-scale pension funds.

"A little bit depends on the size of the fund, so when you're a manager of a £5billion fund for example you do have a lot of sway in terms of governance" *Pension Consultant*

"[The charity] does cut people out but that is now very rare, they would much rather engage with these organisations and, because overall if you take all the different church entities together they have probably got something like £9bn to invest and so they are a significant investor, and if the Chief Investment Officer was to bang on the door of the Chief Executive of Shell or BP he'll get a meeting. So engaging with them and getting them to tell us what their ten year plan is for changing their ways is much better than just saying, 'We don't like Shell or BP and selling a lot of stock'. Because once you've sold it you've got no argument left." *Pension Consultant*

In its report, ***From the Margins to the Mainstream: Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors***, the World Economic Forum reports: "Investors have great influence over the social, environmental and economic challenges of societies, yet operate within a market infrastructure and investment ecosystem where the incentives do not generally balance social, environmental and economic impact. Impact investing – an investment approach intentionally seeking to create both financial return and positive social impact that is actively measured – has been lauded as an emerging investment approach with the potential to reconcile key shortcomings in traditional financial markets."

Impact investing: an investment approach intentionally seeking to create both financial return and positive social impact that is actively measured.

Among the "many constraints" that inhibit institutional investors from allocating capital towards impact investments, the report concludes that "most can be attributed to one of the four broad overarching challenges: early-stage ecosystem, small average deal size, fit within asset allocation framework and double bottom line."

Jane Ambachtsheer, Partner, Chair – Responsible Investment, Mercer says "Voting and engagement are increasing in importance. Impact investing gets a lot of press, but is still relatively niche. ESG integration is the big area that's changed in my view in terms of mainstream managers."

The case for performance

The respondents in our research were aware of the debate surrounding value-based investing and returns, and the majority recognised the 'fiction' that suggests investing according to their values means compromising on performance.

"It is in investors own self-interest to pay more attention to so-called 'sustainability' issues for producing stable, long-term returns."

Robert G. Eccles, Professor of Management Practice, Harvard Business School

After a decade or more of peer-reviewed research there is a substantial body of evidence to show that values-based investing can produce very competitive performance and long-term risk reduction compared with non values-based alternatives:

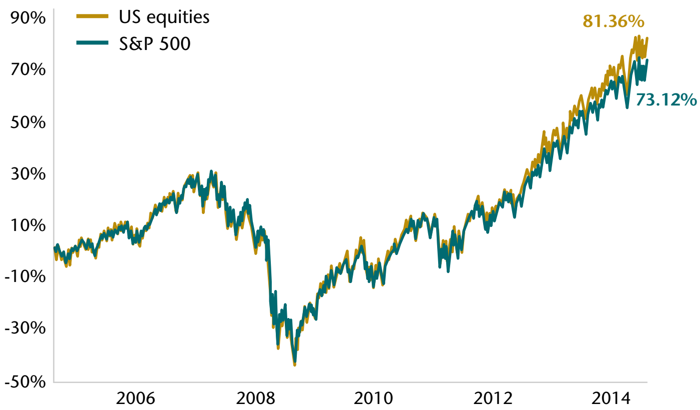
- In October 2007, the United Nations Environment Programme Finance Initiative (UNEP FI) analysed 20 influential pieces of academic work and 10 key broker studies exploring links between different approaches to responsible investment and investment performance. This comprehensive review, ***Demystifying Responsible Investment Performance*** found that SRI investment strategies are competitive with non-SRI strategies from a performance standpoint.
- In November 2009, Mercer issued its report, ***Shedding Light on Responsible Investment: Approaches, Returns and Impacts***, in which it reviewed a further 16 academic studies on SRI and financial performance that were published after the 2007 UNEP FI review. It found that of these 36 studies, published between 1995 and 2009, 20 – more than half – found evidence of a positive relationship between ESG factors and financial performance, and only three found evidence of a negative relationship. It concluded that "a variety of factors, such as manager skill, investment style and time period, is integral to how ESG factors translate into investment performance; therefore, it is not a 'given' that taking ESG factors into account will have a uniform impact on portfolio performance, and we expect significant variation across industries."
- GMI Ratings' 2011 report, ***Ten Things to Know about Responsible Investing and Performance***, reviewed academic literature on the financial performance of sustainable and responsible investing approaches and found that sustainable portfolios perform comparably to conventional ones and that a sustainable approach does not have to be bad for diversification. The GMI Ratings paper draws in part on an academic paper summarising 51 influential studies on responsible investment which have been published in English since the 1990s.
- In 2012, a meta-analysis by DB Climate Change Advisors of more than 100 academic studies, ***Sustainable Investing: Establishing Long-Term Value and Performance***, found that incorporating environmental, social and governance data in investment analysis is "correlated with superior risk-adjusted returns at a securities level" and that sustainable approaches that merely employ exclusionary screens, while showing little upside, do not underperform.

- ***The UN Global Compact-Accenture CEO Study on Sustainability 2013***, surveyed 1,000 CEOs across 103 countries and 27 industries. It found that 80% view sustainability as a means to gain competitive advantage relative to their peers, 63% expect sustainability to transform their industry within five years, and 76% believe that embedding sustainability into core business will drive revenue growth and new opportunities.
- Arabesque Partners' report in association with the University of Oxford, published in September 2014, ***From the Stockholder to the Stakeholder: How Sustainability Can Drive Outperformance***, reports on "more than 190 of the highest quality academic studies and sources on sustainability to assess the economic evidence on both sides for: a business case for corporate sustainability; integrating sustainability into investment decisions; implementing active ownership policies into investors' portfolios."

As Robert G. Eccles, Professor of Management Practice at Harvard Business School says, "It is in investors own self-interest to pay more attention to so-called 'sustainability' issues for producing stable, long-term returns." Or, as Joe Keefe, President and CEO of Pax World Management suggests: "The premise underlying sustainable investing is elegant in its simplicity: companies that do a better job of integrating environmental, social and governance standards into their business models are better positioned than their less-enlightened competitors to provide investment performance over the long term. Therefore, identifying and investing in those companies is arguably a smarter way to invest – avoiding the risks associated with substandard ESG performance while capturing the returns associated with sustainability leadership."

This study compares similar companies over time, one set with a strong ESG programme, and another similar set of companies without an ESG or sustainability emphasis. The

Example 1: ESG returns vs. a non-ESG "benchmark":



The ESG (gold) line for US equities excluding the 200 fossil fuel companies with highest carbon reserves vs. the S&P 500 (green) shows no divergence, and at times even a slightly superior performance.

Source: Thomson Reuters Eikon

Example 2: ESG index return vs. benchmark (benchmark comparisons)

Index provider	ESG / Sustainable Index	Period	ESG Index return	Benchmark return	Benchmark	As of
MSCI	MSCI KLD 400	24 years	10.36%	9.96%	MSCI USA	4/30/14
FTSE	Environmental Opportunities USA	5 years	24.00%	21.20%	FTSE USA	3/31/14
MSCI	MSCI World ESG	5 years	18.50%	18.28%	MSCI World	3/31/14
S&P	US Carbon Efficient	5 years	21.39%	21.16%	S&P 500	3/31/14
MSCI	MSCI EAFE ESG	3 years	8.20%	7.20%	MSCI EAFE	3/31/14

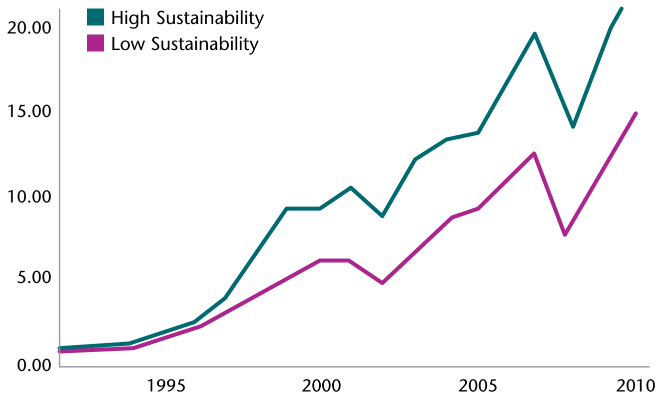
Source: CERES Blueprint for Sustainable Investing

Example 3: Fund return vs. benchmark

Fund Manager	Fund	Period	Fund Return (net of fees)	Benchmark return	Benchmark	As of
ClearBridge Investments	International Value Equity ESG	10 years	6.70%	6.50%	MSCI EAFE	3/31/14
Impax Asset Management	Specialists Strategy	10 years	10.10%	6.97%	MSCI ACWI	3/31/14
Parnassus Funds	Core Equity Fund (Institutional)	10 years	9.71%	7.42%	S&P 500	3/31/14
Portfolio 21	Global Equity (PORIX)	10 years	7.21%	6.97%	MSCI ACWI	3/31/14
RobecoSAM	Smart Energy Strategy	10 years	7.55%	6.83%	MSCI World	3/31/14
RobecoSAM	Sustainable Water Strategy	10 years	9.58%	6.83%	MSCI World	3/31/14

Source: CERES Blueprint for Sustainable Investing

Example 4: Company comparison

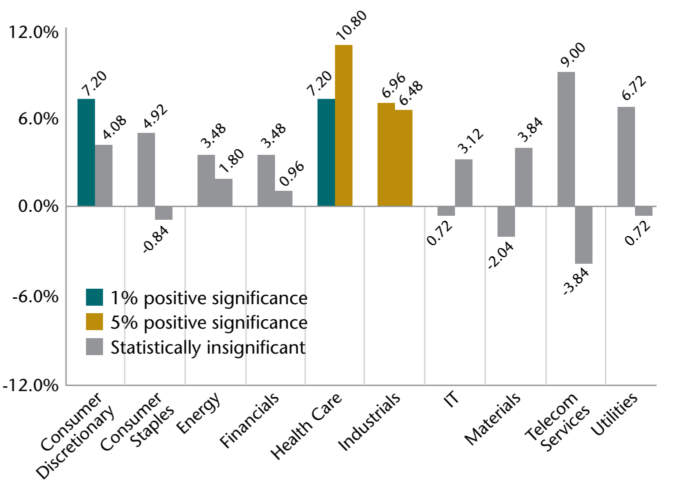


Source: Source: Robert G. Eccles, Ioannis Ioannou, and George Serafeim, 2011: The Impact of Corporate Sustainability on Organizational Processes and Performance

group of companies with superior sustainability profiles outperformed their peers in terms of both stock market value and financial performance.

As with all investing, choice of sector and fund can significantly affect returns. This study examined where there was statistically material outperformance using ESG filtering. Note: the three green-shaded bars for the sectors "Consumer Discretionary", "Health Care" and "Industrials", all produced a statistically relevant outperformance over time.

Example 5: The influence of fund and sector choices



Source: Hoepner, Yu & Ferguson (2010)

From a wider management viewpoint, including McKinsey's well-informed perspective[19], the message is much the same: "Sustainability – a term we use to describe the business programs, products, and practices built around environmental and social considerations – is often seen as a luxury investment or a public relations device. We think that view is cynical and increasingly untenable. In fact, a growing body of evidence indicates that sustainability initiatives can help to create profits and business opportunities. McKinsey recently launched a knowledge collaboration with more than 40 companies to understand their sustainability challenges. We sought to develop a set of practical recommendations for companies to capture value from sustainability. In doing so, we found that leading companies pursue sustainability because it has a material financial impact. The value at stake from sustainability-related issues – from rising raw-material prices to new regulations – is substantial."

In its research, McKinsey cites the work of three economists, two from Harvard and one from the London Business School, suggesting that sustainability initiatives can help to improve financial performance. "The researchers examined two matched groups of 90 companies. The companies operated in the same sectors, were of similar size, and also had similar capital structures, operating performance, and growth opportunities. The only significant difference: one group had created governance structures related to sustainability and made substantive, long-term investments; the other group had not.

According to the authors' calculations, an investment of $1 at the beginning of 1993 in a value-weighted portfolio of high-sustainability companies would have grown to $22.60 by the end of 2010, compared with $15.40 for the portfolio of low-sustainability companies. The high-sustainability companies also did better with respect to return on assets (34 per cent) and return on equity (16 per cent).

No wonder, then, that investors are increasingly comfortable with the idea of putting their money into socially responsible investment. In the United States, such investment grew by 486 per cent between 1995 and 2012, outpacing the broader universe of managed US assets, which grew by 376 per cent over the same period."

Sustainable investing: risk or opportunity?

The compelling evidence that sustainable, responsible investment strategies can not only mitigate risk but also deliver strong returns nonetheless leaves some institutional investors struggling to embrace these strategies and readily integrate them into their investment process.

Taking ESG principles is a good starting point, but sustainable investing has the potential to take investors much further, to not only mitigate risk but also harness opportunity for long term returns.

19. McKinsey (2014). Profits with purpose: How organizing for sustainability can benefit the bottom line.

Working through what Mercer describes in terms of a Framework for Sustainable Growth is one such starting point. This is a three-step process for helping investors to establish and embed a consideration of sustainability into their investment process, starting with the foundation of beliefs and evolving to processes: how you appoint external managers, how you measure their success, how you pay them, how you communicate your results, and then addressing the portfolio so that it will naturally evolve as a result of enhancing and embedding those beliefs in the investment process.

Given the evident importance of sustainability as a predictive factor of investment returns, Peter Michaelis, Head of Equities at Alliance Trust Investments, said that institutional investors should at the very least be asking their asset managers three initial questions:

1) What account if any do you take of environmental, social or governance factors in investment decisions (since UNPRI signatories all claim to do this, 'None' should not be a common answer);
2) Who carries out the ESG analysis and how do you integrate it into an investment decision? (The further the ESG analysis is from the decision maker, the less important it is likely to be);

AND

3) Which of your last dozen trades, for instance, were driven by an analysis of ESG factors?

Framing the conversation in this way should provide investors with a clearer view of how much weight is being given to sustainability by their asset managers. A good place to start the conversation.

Conclusion

One of the most important drivers behind the adoption of sustainable investing is that ESG issues impact a company's bottom line: the risk of failing to incorporate these factors is very real.

In addition to the profound economic relevance of this approach, to support long-term risk-adjusted returns, there is also a growing focus on the opportunities that sustainability and ESG-based investments offer, across asset classes. Tomorrow's opportunities are present in the companies and markets that are currently developing the technologies and infrastructure that will support tomorrow's world: it makes nothing more or less than financial sense to invest in them.

Beyond risk and return is the influence of beneficiaries on those who are investing and managing assets. Institutional investors have a duty of care to their beneficiaries to take the long-term decisions that are in their best interests and must continue to respond in ways that are relevant. As one respondent put it: "young people today are the most sustainability-conscious yet and have much more power, through social media and the transparency that brings, to influence change – change for the better that they see as important to their future."

Or more simply: how we decide to invest today shapes the world future generations will inherit.

Method

This report is based on a qualitative survey of 30 institutional investors and consultants during June, July and August 2015 undertaken by Gabriel Research & Management Ltd. For reasons of client confidentiality, some comments are not attributed.

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