InvestmentMetrics

ESG Investing by Global Managers

A Survey on Participation, Performance, and Process

by InterSec Research

The debate over environmental, social, and corporate governance (ESG) factor analysis and its importance in the investment evaluation process has been revived in North America. Last year, Harvard Management Company and the University of California's endowment became Principals of Responsible Investing (PRI) signatories. The PRI pledge is a United Nations initiative to promote the importance and practice of ESG factor analysis. These principals have been widely adopted in Europe but have been met with resistance in North America. In order to get a gauge of the current mood of investors on this topic we conducted an anonymous survey of 12 North American asset owners (pension plans and endowments & foundations), 10 U.S. investment consultants, and 38 asset managers. Additionally, we reviewed the performance and team structures of the PRI signatories.

Summary

Investing policies shaped by environmental, social and governance (ESG) guidelines have evolved over 40 years from an informal cause among a few dedicated investors to a major theme in global institutional investing. Ten years ago the United Nations formalized the trend by stating its Principles for Responsible Investment, and today nearly one-third of global institutional investment (estimated at US$21.4 trillion at the start of 2014) follows ESG principles. The demand for socially responsible investment has been met by corporate managements around the world, who have responded with more enlightened policies on human rights, labor practices and care for the environment, among other factors.

Accordingly, investors have come to expect an awareness of ESG from their investment managers and consultants, with two motivations. The first is the desire to promote social welfare and conservation of scarce resources. Second is the positive financial results that ESG policies have generated: corporations with a social consciousness tend to outperform in their financial results, and in their returns to shareholders as well.

InterSec Research recently conducted a survey on attitudes toward ESG among U.S.-based asset owners, investment consultants and asset managers. Stated briefly, formal participation in the United Nations Principles for Responsible Investment (UN PRI) is not prevalent among asset owners or investment consultants, but a majority of asset managers responding indicated they had signed the UN PRI or intended to do so.

As a practical matter, however, adopting ESG practices in investment policies is more widespread, particularly among investment consultants and asset managers. About 40% of asset owners in the survey believe that adding ESG factors to the investment process makes a positive contribution to returns.

We also examined the historical performance of asset managers according to their participation in the UN PRI. Among global and international strategies, managers that were PRI signatories typically showed better performance than non-signatories, with the largest advantage coming in global strategies benchmarked against the MSCI World index. Adding ESG factors was not as productive for managers of emerging markets strategies, however. As for client appetites for products from PRI Signatories, recently more than half of new assets flows into global, international and emerging market strategies have been directed to PRI Signatories.

Socially Responsible Investing: A Global Imperative

In September 1970, *The New York Times* published "The Social Responsibility of Business is to Increase its Profits[1]," an article authored by economic scholar Milton Friedman. Corporate managements of the day had begun to give attention to matters outside their own boardrooms, including, as Dr. Friedman expressed it: "providing employment, eliminating discrimination, avoiding pollution and whatever else may be the catchwords of the contemporary crop of reformers." He made the contrary case – that the sole responsibility of business is to earn profits, deeming other concerns to be "pure and unadulterated socialism," and contending that the businessmen who espoused them were "unwitting puppets of the intellectual forces that have been undermining the basis of a free society…" Individuals might act on social concerns and responsibilities, he wrote, but corporations should not. *

Friedman's view seems well out of date today. And it may have been in 1970 as well: social responsibility in business has a long history in the United States, whether originating from corporations' actions and behaviors, or from the portfolio choices made by investors. Dating back to the 18th century, both the Methodist Church and the Religious Society of Friends avoided investing their monies, on religious grounds[2], in slavery, liquor, gambling and war. More recently, in the late 1940s, mutual fund manager Pioneer Investments developed an investment strategy that drew the line at gaming, distilling and brewing, and tobacco products, but from a perspective emphasizing businesses that provided products and services that were truly useful.[3]

Then during the 1970s and following, a number of

* Friedman did allow, however, that companies should "engage in open and free competition without deception or fraud."

investment firms, such as Pax World Investments, Calvert Investments, and Domini Social Investments, were founded to pursue what was known as "socially responsible investing," primarily for retail investors through mutual funds.

Financial scandals early in this century, such as those bringing down Enron, WorldCom and Global Crossing – and the subsequent imposition of heavy government regulation – severely damaged the reputations of big corporations around the world. Those events demonstrated to corporate managements the importance of protecting and building their reputations with investors. Accordingly, in the last 10 years, corporations' awareness of their broader societal role has expanded significantly, and now environmental, social and governance (or ESG) concerns are high on the agendas at most companies.[4] And not just for appearances' sake: a 2011 study by academics from Harvard and Oxford concluded that "high sustainability" companies provide higher-quality financial disclosures, and significantly outperform their competitors both as to earnings growth and returns to shareholders.[5]

Non-governmental organizations have also focused on corporations' responsible behavior as citizens of the world,[6] and in 2006 the United Nations formalized socially-oriented investing with the introduction of its Principles for Responsible Investment, or PRI.[7] Natural resources, climate change, human rights, labor standards and ageing populations all are important issues for global business and the financial markets, says the United Nations, which sees a growing recognition that tending to ESG issues is a basic part of investment performance over the medium and long term.

ESG concerns feature prominently in today's institutional portfolios. In particular, asset owners who oversee investment for public retirement plans, or endowments and foundations with a social orientation, seek out investment managers following ESG processes. The United Nations reports as signatories to its PRI 287 asset owners, 909 investment managers, and 196 professional service partners.[8] Moreover, four of the 10 largest U.S. public retirement plans are signatories to the United Nations PRI.[9]

The Forum for Sustainable and Responsible Investment (or US SIF), a Washington, D.C.-based organization of investment managers, institutions and organizations engaged in responsible investing, reported a total of US$6.75 trillion in U.S. investors' assets with managed a socially responsible bent in 2014. The Global Sustainable Investment Alliance, of which the US SIF is a member, reported a global total of US$21.4 trillion following ESG principles at the start of 2014, or 30% of professionally managed assets, up from US$13.3 trillion in 2012.[10]

Industry Survey

In view of the growing importance of ESG investing, in August 2015, InterSec Research conducted a survey among global investors on their participation in, and acceptance of, ESG principles. Responding to the 10-question survey were 12 asset owners, 10 consulting firms and 38 asset managers. All asset owners were either public retirement plans or endowments and foundations – two investor groups that have shown particular interest in ESG investing practices.

Acceptance of the United Nations Principles for Responsible Investing

Among the 12 asset owners responding, 25% had signed the United Nations PRI. Of those that had not signed, nearly all indicated that they did not plan to sign them.

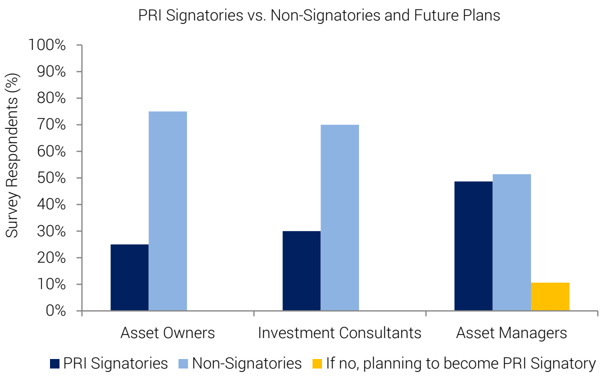
A minority of investment consultants – 3 of the 10 responding – had signed the UN PRI. None of the non-signers showed an intention to do so in the future.

However, asset managers have shown greater engagement. Just under half of the 37 respondents said they had signed the UN PRI. Of those not signing, 11% indicated they had intentions to sign.

Responses are summarized in Exhibit 1.

Exhibit 1

Source: InterSec Research survey, August 2015



Aside from the formal step of signing the UN PRI, we also surveyed the group on their uses and views on ESG principles generally.

ESG in the investment process

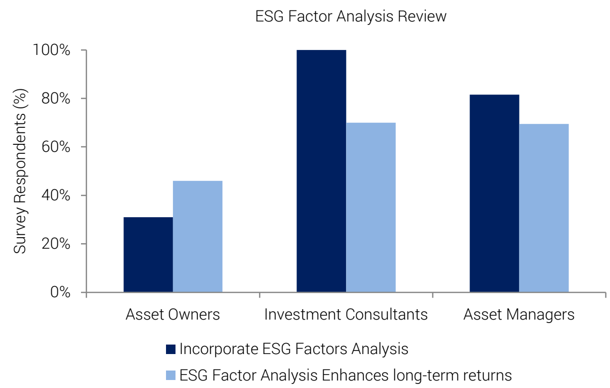
One quarter of asset owners, or 3 of the 12 responding, said that they took ESG factors into account in choosing and monitoring their external managers. Among investment consultants, all of the nine responding incorporate ESG in manager research, and among asset managers, 82% of the 38 in the survey build ESG factors into the investment process (Exhibit 2).

Impact of ESG

We asked the three groups about their belief in the ability of ESG to enhance long-term returns. Patterns in responses followed those on incorporating ESG in portfolio decisions (Exhibit 2).

- Of asset owners, 42% believed ESG factors made a positive contribution to returns. Among the 58% that did not, half offered the explanation that incorporating ESG would restrict the investment opportunity set, 33% did not see ESG as an important factor, and 16% said that incremental costs would outweigh potential benefits.
- For investment consultants, 70% believed that ESG could enhance investment returns. Those that did not were split evenly between the limitations ESG might place on the breadth of investment opportunities, and simply not believing in its importance.
- Most investment managers, about 70%, believed in the potential of ESG practices to add to returns. Of the few that did not, most cited the drawback of a smaller opportunity set.

Exhibit 2



Source: InterSec Research survey, August 2015

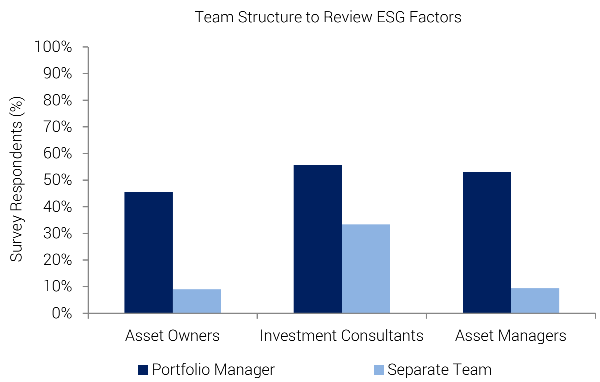
Implementation of ESG factor analysis

ESG factors can be added to a manager's investment process in several ways: through a separate team of in-house researchers dedicated to ESG; by the strategy's analysts or portfolio managers as a complement to their other research; or via monitoring of portfolio choices by third parties.

- Nearly half of asset owners indicated no preference for method, but of those that did, the great majority favored ESG monitoring by the strategy's analysts and portfolio managers. A few preferred to assign the monitoring to a separate team.
- Investment consultants also favored that ESG be carried out by analysts or portfolio managers tied to a strategy (56% expressed that preference). One-third of consultants responded in favor of a separate team of analysts.
- Asset managers also voted for the joint strategy analyst/portfolio manager approach (53% of the 32 firms responding). A separate research team approach was favored by 9% of managers, and a third-party review by 6%. Four of the 32 managers responding, or 13%, cited a combined approach to ESG monitoring.

Exhibit 3 summarizes the relevant survey responses.

Exhibit 3



Source: InterSec Research survey, August 2015

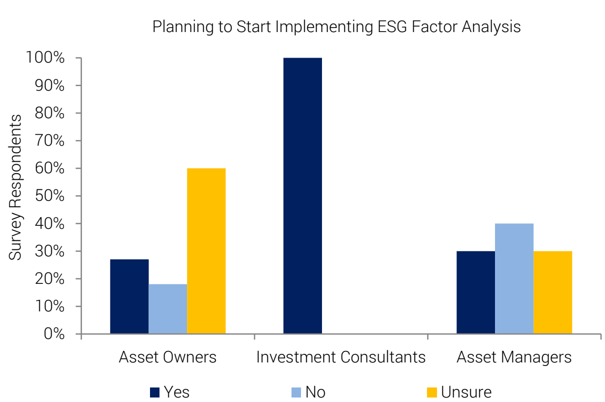
Future intentions for ESG

We ended our survey with a question to those who have not implemented ESG on their future plans.

- Among the 10 responses from asset owners, 20% said they intend to add ESG to the investment process, and 20% said they would not, while 60% were uncertain.
- Three investment consultants shared their intentions: all said they would implement ESG factors.
- Asset managers are split: 30% of the 10 respondents said they plan to add ESG to their processes, while 40% do not, and 30% are uncertain.

Exhibit 4 illustrates these responses.

Exhibit 4



Source: InterSec Research survey, August 2015

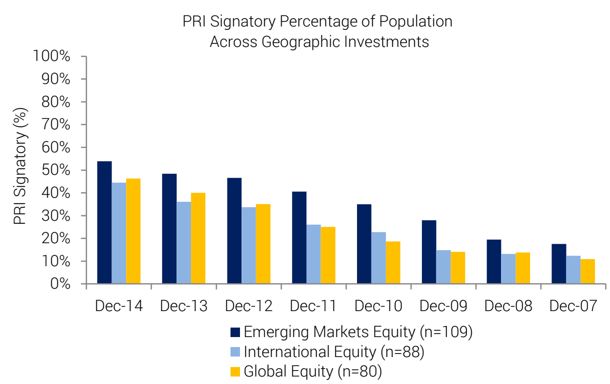
ESG and investment performance

To complement the survey on asset owner, consultant and manager interest, we also drew on performance measures from the InvestWorks database, which has gathered observations on managers' inclination toward ESG principles dating back to 2007.

ESG participation

An increasing proportion of managers in our database have aligned with the United Nations PRI principles since 2007: among Global Core managers, 46% participated in PRI at year end 2014, up from 11% in December 2007. For International Core managers, 44% were PRI signatories at year end 2014 versus 12% in 2007, and among Emerging Markets specialists, 54% had affirmed PRI principles in 2014 versus 18% in 2007 (Exhibit 5).

Exhibit 5: Manager participation in UN PRI principles



Source: InvestWorks manager database

Returns of ESG managers

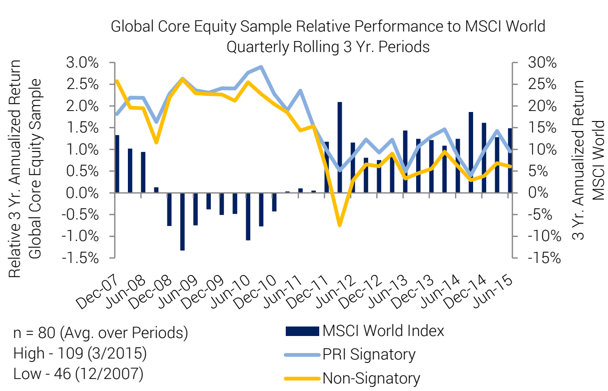
Within the InvestWorks database, managers of global and international strategies who are PRI signatories, and thus have committed to incorporating ESG factors into their portfolio selections, have generally demonstrated better average performance than their benchmarks since 2007. Importantly, this result is contrary to the opinion held by many in the survey that an ESG investment process would likely lead to underperformance, due to restrictions on the opportunity set. However, relative performance has not been as strong among the subset of PRI-signatory Emerging Markets specialists.

Global strategies

For global strategies in the InterSec Research database, the relative performance of PRI signatory managers versus non-signatories has been mixed.

For quarterly three-year periods between December 2007 and June 2015, global developed-market core strategies in the ISR database from both signatory and non-signatory managers tended to beat the MSCI World benchmark. However, PRI-signatory managers maintained a slight advantage in most periods (shown by the light blue line versus the gold line in Exhibit 6), averaging an excess return of 0.34% annualized for the three years ended June 2015 (0.95% for signatories, versus 0.61% for non-signatories). PRI-signatory managers earned superior returns in 30 out of 31 total quarters in the full sample period, or 97% of the time.

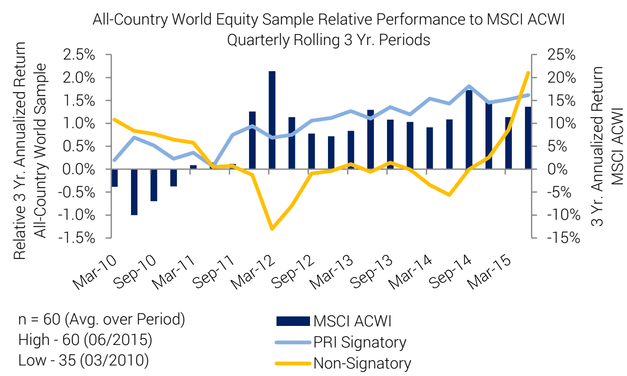
Exhibit 6:



Source: InvestWorks manager database

For broader global strategies managed against the MSCI ACWI, managers that were UN PRI signatories showed consistent and significant outperformance from March 2011 through June 2015, measured on rolling three-year periods. (In Exhibit 7, the light blue line plots performance of the signatory group, while the gold line shows the performance of non-signatory managers.) For the three-year period ended June 2015, non-PRI signatory managers earned annualized excess returns of 2.10%, versus 1.62% for signatories. In the full sample period, PRI-signatory managers earned superior returns in 16 out of 22 total quarters, or 73% of the time.

Exhibit 7:



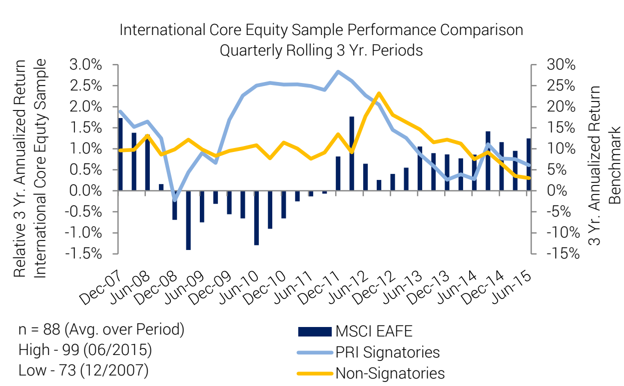
Source: InvestWorks manager database

International strategies

For managers of international strategies, following ESG principles in portfolios showed mixed results as measured by excess returns.

In international core strategies, for rolling three-year periods of quarterly returns from December 2007 through June 2015, PRI-signatory managers showed returns superior to non-signatory counterparts in 19 quarters, or 61% of the time. Signatory managers did earn sustained outperformance, however, from mid-2009 through mid-2012. The light blue line in Exhibit 8 shows performance of signatory managers; the gold line shows performance of non-signatories. For the three years ended June 2015, PRI signatory managers of international core strategies earned annualized excess returns of 0.61%, versus 0.30% for non-signatories.

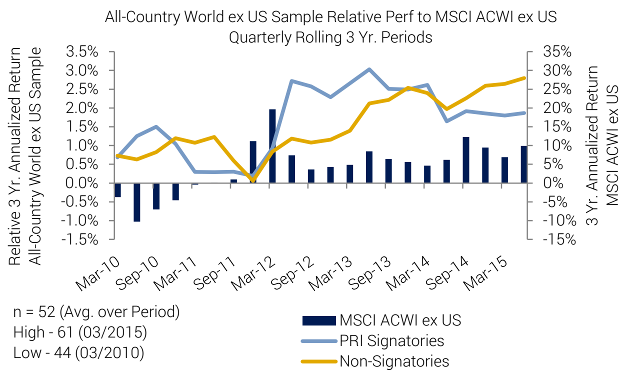
Exhibit 8:



Source: InvestWorks manager database

For international strategies benchmarked to the broader MSCI ACWI-ex US index, PRI-signatory managers fared worse than core managers. For the three years ended June 2015, ESG-oriented managers earned excess returns of 1.86% versus 2.80% for non-signatories. Over the full period, performance was split between the two groups, with both signatory and non-signatory managers showing better returns in 50% of quarters between March 2010 and March 2015.

Exhibit 9:



Source: InvestWorks manager database

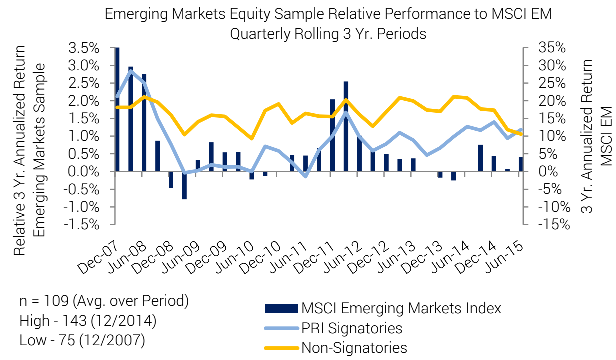
Emerging Markets strategies

Participation in PRI principles is highest among emerging markets managers – at 54% at the end of 2014 – and their recent performance has shown a small edge over that of non-signatories. Since December 2007, as measured by three-year rolling quarterly returns, non-signatory managers have consistently outperformed signatories – in 4 of 31 total periods, or 13%. (The gold line in Exhibit 10 plots performance of non-signatory group, while the light blue line shows the performance of PRI-signatory managers.) As of June 2015, signatory managers delivered 1.18% in excess return above the MSCI Emerging Market benchmark for three years, versus 1.06% for non-signatories.

Team Structure

Within the universe of PRI signatories, managers can carry out research of ESG characteristics of portfolio candidates in several ways. In some cases ESG research is assigned to a dedicated analyst team, while in others a strategy's portfolio managers and analysts are given the

Exhibit 10:



Source: InvestWorks manager database

additional responsibility for monitoring ESG factors. A small group of firms relies on research from third parties, while yet another approach integrates the efforts of a separate team with those of portfolio managers. Exhibit 11 details the prevalence of the different modes for the combined group of global, international and emerging market strategies.

Exhibit 11: Asset managers' approaches to ESG analysis

ESG factor analysis structure

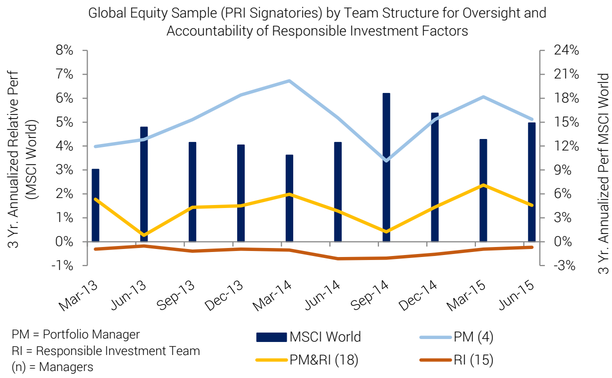
Strategy portfolio manager / analysts	53%
Separate team	9%
Third parties	6%
All sources	13%
Not applicable	19%

Sample size = 32

Source: InvestWorks manager database

Among managers of global strategies, most firms employ the combination of an in-house specialist research team with the strategy's portfolio manager (18 of 41 total firms), and nearly as many, 15, rely on just an in-house team. (The legend in Exhibit 12 details the number of firms choosing each technique.) Just four leave ESG research to the portfolio manager, but this group gets the best results in terms of excess return (shown by the light blue line in Exhibit 12). For the three years ended June 2015, the portfolio manager group earned excess returns of 5.1% over the MSCI World benchmark, versus 1.5% for combined portfolio manager/in-house research teams, and -0.2% for in-house researchers.

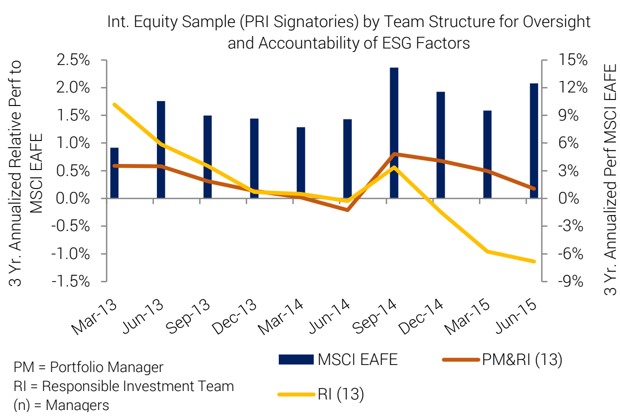
Exhibit 12:



Source: InvestWorks manager database

Among the 31 PRI-signatories managing international strategies in the ISR database, about half conduct ESG research through dedicated in-house teams alone, and the remainder relies on the combined efforts of specialist researchers and portfolio managers. For the three years ended June 2015, better performance was earned by the combined portfolio manager/research team approach, with excess return of 0.2%, versus -1.1% for the dedicated in-house research teams alone (Exhibit 13).

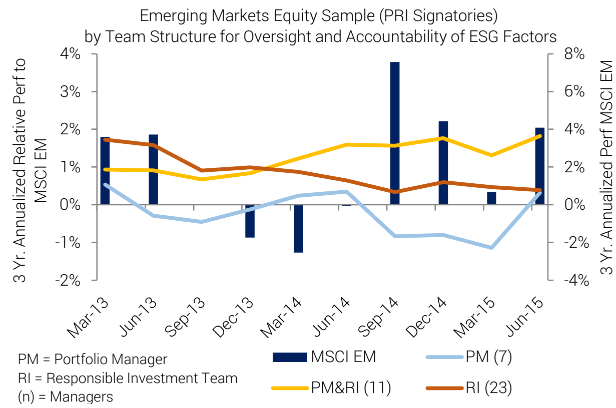
Exhibit 13:



Source: InvestWorks manager database

Among PRI-signatory managers of emerging market strategies (totaling 41 in the ISR database), over half, or 23, employ in-house research specialists, while 11 rely on teams of portfolio managers and researchers, and seven rely on only the portfolio manager. In terms of excess returns, the portfolio manager/research teams have seen the best results, earning 1.8% over the MSCI Emerging Market index in the three years ended 2015, followed by the in-house research teams (earning 0.4% in excess return) and portfolio managers alone (0.3%).

Exhibit 14:

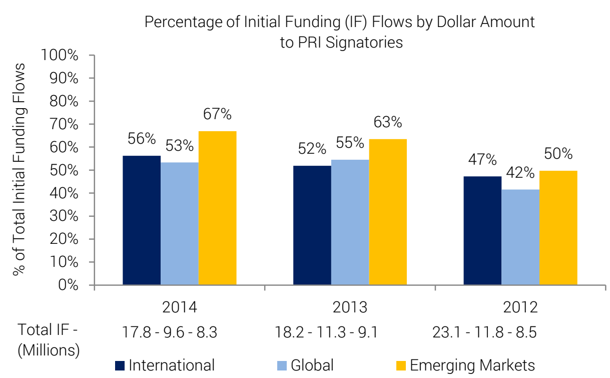


Source: InvestWorks manager database

Client asset flows to ESG-oriented managers

We end this analysis with a look at the new business wins at managers that are signatories to the UN PRI principles. Exhibit 15 illustrates the initial funding of new mandates to such managers for 2012 through 2014. It shows that PRI-oriented managers are winning an increasing share of new business – rising to over half in 2013 and 2014 – and that the largest portions have gone to ESG-sensitive emerging market strategies (shown by the gold columns).

Exhibit 15



Source: InterSec Research

Endnotes

[1] *The New York Times Magazine*, September 13, 1970

[2] "History of socially responsible investing in the U.S.", Reuters, August 9 2013

[3] Pioneer Investments fact sheet, 2014

[4] *Profits with purpose: How organizing for sustainability can benefit the bottom line*, McKinsey & Company, 2014

[5] *The Impact of Corporate Sustainability on Organizational Processes and Performance*, Robert G. Eccles, Ioannis Ioannou, and George Serafeim. ssrn.com/abstract=1964011

[6] "Just Good Business," *The Economist*, January 19, 2008

[7] www.unpri.org

[8] www.unpri.org/signatories/signatories/

[9] "Growth slows for top 300 plans' assets," *Pensions & Investments*, September 1, 2014

[10] *2014 Global Sustainable Investment Review*, Global Sustainable Investment Alliance

Investment Metrics

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