

The Frontier Line

Thought leadership and insights from Frontier

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**ESG assessment
of managers**

About us

Frontier has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on \$600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Frontier's purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.



Simone Gavin
Senior Consultant

Simone Gavin re-joined Frontier in May 2020 as a Senior Consultant and is a member of the Equities Team. Simone previously worked at Lonsec for seven years where she was responsible for undertaking manager research in global and domestic equities, with lead analyst responsibilities for global equities and emerging market equities. Prior to Lonsec, Simone spent five years at Standard & Poor's where she also undertook manager research in global and domestic equities and had lead analyst responsibilities for listed infrastructure and emerging market equities. Simone previously worked with Frontier as an analyst for two years until November 2007. Simone holds a Bachelor of Chemical Engineering (hons) and Commerce from The University of Melbourne and is RG146 compliant.



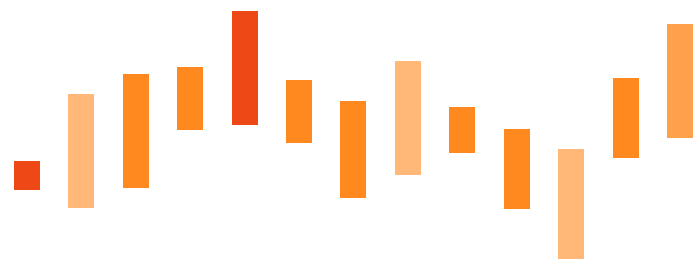
Fraser Murray
Head of Equities

Fraser joined Frontier in 2012 and is the Head of Equities. He was previously at Ibbotson Associates/Intech Investments for nearly 15 years where he held a variety of roles including five years as Head of Manager Research and five years as Head of Equities and Property. Fraser started his asset consulting career at Towers Perrin in 1994 as a Research Analyst in its Melbourne and London offices. Fraser holds a Bachelor of Commerce with Honours from the University of Melbourne and a Graduate Diploma of Applied Finance and Investments from Finsia, and is a Fellow of Finsia.

Why is ESG important in manager assessment?

Frontier's view is that strong, fit-for-purpose ESG processes are important for all managers.

In addition to ESG consideration being increasingly aligned with the values of underlying investors (such as super fund members), we believe active managers are better able to achieve their investment objectives through appropriate consideration of ESG factors, including climate change, as part of their investment process. We also believe ESG consideration is very important for passive managers. Through their ownership of almost every stock, passive managers can, and should seek to improve the performance of equity indexes themselves through incorporation of ESG factors. For all managers, we believe value can be created, not through exclusion, but through engagement and proxy voting.



The creation of the Frontier 'Manager ESG Assessment Toolkit'

Frontier has been assessing the ESG capabilities of managers for many years, but since 2019, has had ambitions to improve the robustness, consistency and granular detail in these assessments.

The primary objective of these ambitions was to better facilitate our clients in differentiating between investment products on ESG grounds.

After an extensive review process in 2020, Frontier finalised a new and comprehensive scoring system for our sector research teams to use in assessing ESG credentials when rating both active and

passive managers (in all asset classes). This is known internally as our 'Manager ESG Assessment Toolkit'. The assessment process involves completion of a standard responsible investment (RI) questionnaire supplemented by targeted dialogue with each manager specifically on ESG matters. The culmination of the process is our findings being incorporated into a multi-dimensional scoring system, which ultimately determines an ESG score (which is one of six dimensions assessed concurrently in forming a rating of a particular strategy).

A trial period was conducted in the second half of 2020 and, following some minor adjustments, the Manager ESG Assessment Toolkit has since become a formal component of the Frontier manager rating process.

Breakdown of the scoring criteria

Frontier's ESG assessment approach covers seven areas that are each required to be scored by the research teams.

1A | RI Philosophy and Policy

Does the manager have a philosophy and how is it endorsed, monitored, evolved?

1B | RI Governance

What is the organisational governance structure and roles and responsibilities when it comes to ESG incorporation?

2 | RI Resourcing

Does the manager have a dedicated ESG team or how are investment personnel trained on ESG issues?

3A | RI Objectives

What are the objectives for integrating ESG factors into the investment approach (at the product level)?

3B | ESG Integration Process

How are ESG factors integrated into each phase of the investment process?

A questionnaire was designed to collect information on these seven categories and, in combination with dialogue with the manager specific to these seven categories, research teams now apply scores on a scale of 1-3 (a score of 1 suggesting lagging the peer average, a score of 2 representing in line with the peer average and a score of 3 representing ahead of the peer average). In practice, some of these seven sections are sub-divided further.

4 | Active Ownership

What is the engagement process including gaining access to suitable personnel and how has it influenced investment decisions and performance outcomes?

5 | Collective Activity on ESG

What is the rationale of participating/not participating in collective efforts alongside peers and/or other entities on ESG issues and what is the process?

6 | Climate Change

What are the material investment risks and opportunities arising specifically from climate change which you expect to impact performance and how do you determine these?

7 | RI Reporting and Servicing

Do you provide ESG/RI research to clients and what is standard ESG reporting.

Assigning the overall ESG score

These underlying scores are aggregated using a proprietary system to establish a single ESG assessment on a scale of 1-5 stars (with 1 star being the lowest score and 5 stars being the highest score).

The different Frontier research teams may apply slightly different weighting systems to the various scores in arriving at the combined view. These weights were determined during the trial period and reviewed by Frontier's Responsible Investment Group as well as Frontier's Manager Ratings Committee. For example, the Equities Team applies a higher weighting to active ownership compared to Frontier's other research teams. This is justified as the ownership rights of shareholders (versus bondholders, for example) are more significant and there is greater scope to influence outcomes of company management through both engagement and proxy voting.

Scoring results of the Equities Team to date

As of May 2022, the Frontier Equities Team has now scored 55 different strategies using the Frontier Manager ESG Assessment Toolkit.

This includes 24 global equities (including global small caps) strategies, 10 emerging markets strategies and 21 Australian equities (including Australian small caps) strategies. While several of these assessments were undertaken for newly rated investment products, the majority were completed for previously rated products as a way to 'refresh' our view on the relevant manager's ESG capabilities.

We were and remain highly interested to see the summarised findings to ascertain whether there were any particularly notable observations since our adoption of this approach.

However, before disclosing these results and seeking to interpret these, we think it is important to highlight one particular and significant bias that is likely to be reflected in these results – Frontier's long-held stance on the importance of responsible investment. Frontier has a series of ESG beliefs and these underpin our responsible investment philosophy, which in turn, is a fundamental component of our overall investment philosophy.

In addition, Frontier recently signed the Net Zero Investment Consultant Initiative (NZICI) and is a proponent for continued progress in these ambitions. Given our strong ESG beliefs, Frontier has likely exhibited a positive skew towards managers with better than average credentials in ESG when selecting products we intend to recommend to clients. Notwithstanding this present bias, we also assess managers across other dimensions as well as ESG, so we still expected to see manager results that spanned the full spectrum of 1-5 ESG stars.

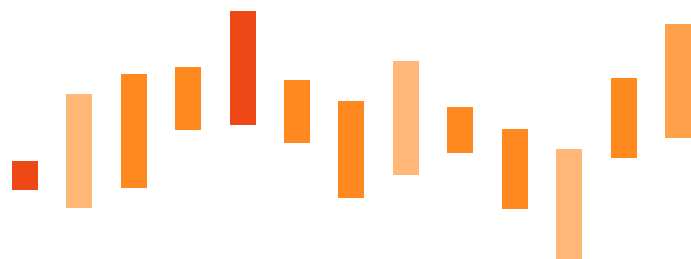
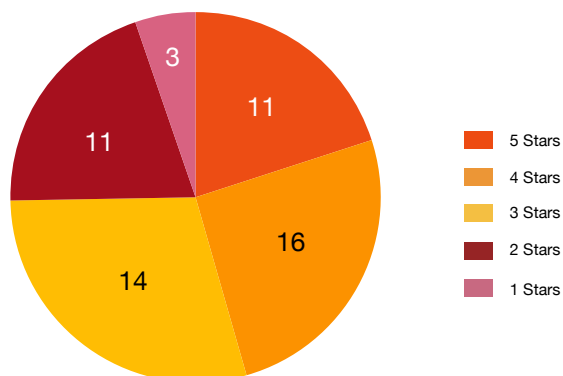


Chart 1 shows the ESG stars achieved by the 55 strategies:

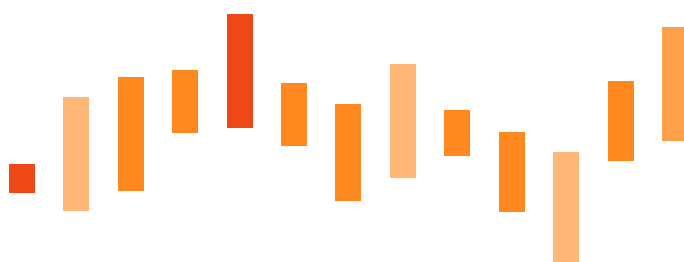
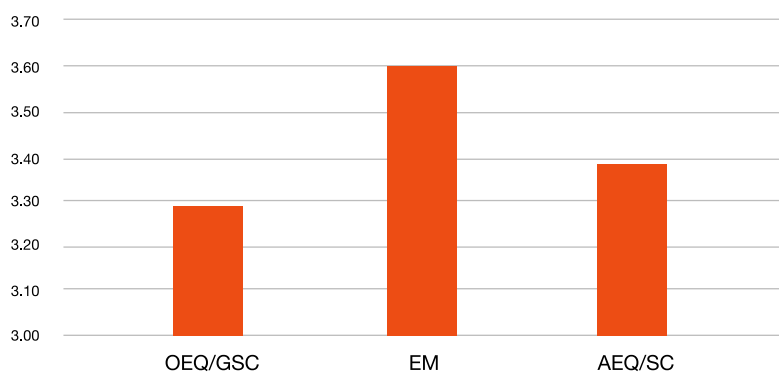
Chart 1: Summary of ESG stars



As expected, equities managers have scored across the full (1-5) ESG star spectrum, although pleasingly only three strategies (all quantitative strategies) had the lowest score of 1 star.

Chart 2 shows the average scores for the 55 strategies, as well as the breakdown into global equities (including global small caps), emerging markets equities and Australian equities (including Australian small caps):

Chart 2: Average score (ESG stars)

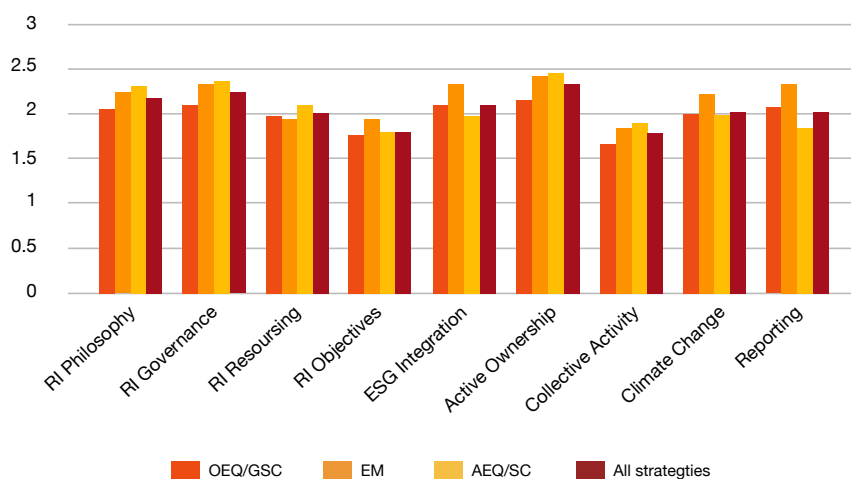


The findings confirm our pre-conceived bias that Frontier's ESG assessments would be above an 'average' of 3.0 (with an overall average of 3.38 ESG stars being achieved). Perhaps more interesting was the finding when it came to the underlying sub-asset classes. Given climate risks are particularly heightened in the Australian economy, we may have expected Australian equities managers to score the highest. Instead, however, the ten emerging markets equities managers had clearly the highest average score on our Manager ESG Assessment Toolkit. On reflection, Frontier feels this outcome is actually not surprising at all. Emerging markets equities is an asset class where all three E, S & G factors likely lag the developed world on average and Frontier has skewed its manager selection to those managers with the strongest ESG credentials when navigating through its complexities.

Within the global equities and Australian equities categories, it was considered significant that the global small caps and Australian small caps offerings scored well below the average, with average scores of 2.0 and 2.7 respectively, although noting the smaller sample size. This was also not surprising as we acknowledge the managers offering these strategies are often proportionately more lowly resourced relative to those offering broad cap strategies in global and Australian equities (and less advanced in their responsible investment consideration). There is a reasonable argument these small caps strategies could be scored separately to the broad caps managers (i.e. relative to a small caps peer average) and that would improve the ESG stars these managers achieved. The counter argument is that equities are equities and to apply a lower standard purely because a manager is investing in the smaller-cap cohort seems illogical. To date, within Frontier's Equities team, we have resisted setting lower standards as we do not believe clients expect lower standards from their small caps managers (or any other sub-group of equities managers).

Delving deeper, we look at the nine sub-scores to see what information this conveys, using the 1-3 points system of each underlying assessment area and as stated earlier, these are scored on a scale of 1-3 (a score of 1 suggesting lagging the peer average, a score of 2 representing in line with the peer average and a score of 3 representing ahead of the peer average):

Chart 3: Scores of underlying assessment areas



Seven of the nine categories achieve an average score above 2.0. Active ownership is the highest scored category and there are two categories which score below 2.0 (being RI Objectives and Collective Activity). A strict interpretation of the process would suggest Frontier is favouring managers that are, on average, below peers when it comes to undertaking collective activity and in articulating their RI objectives. In practice, making assessments versus a 'peer average' is a difficult exercise, particularly when starting a new scoring process. Our sense is that we have scored these categories, to at least a partial extent, relative to what Frontier expects of investment managers in these areas. For example, equities managers using a fundamental approach have actively engaged with companies for many years and it is entrenched in their process, so it is perhaps no surprise it is a category that has scored highly. On the flip side, so equities managers have historically been far more reluctant to participate in collective activity (whether via participation in industry working groups or through collaborating with other shareholders in the companies they own). Frontier is of the view fund managers can do more (and should do more) when it comes to seeking to influence outcomes via channels other than their own direct engagement with the companies. This Frontier viewpoint appears to be reflected in the results rather than a true assessment of collective activity versus the peer average.

On the one hand, the scoring outcome with collective activity could be interpreted as an imperfection in the Manager ESG Assessment Toolkit. On the other hand, this scoring outcome potentially provides an insight that collective activity is the key area where we believe the investment manager community can improve the most and achieve better outcomes for investors with a heightened effort.



Summary of findings

Since 2020, Frontier has adopted the Manager ESG Assessment Toolkit and this was a pivotal step in a more advanced assessment of Manager's ESG credentials.

This approach has become the standard for all four of Frontier's sector research teams. Within Frontier's Equities team alone, to date, 55 strategies have been assessed using the updated criteria. This has included assessments of some industry leaders in responsible investment (achieving the maximum 5 ESG stars) as well as some clear laggards (achieving the lowest possible 1 ESG star only).

In terms of key observations (based off this sample to date):

- Active engagement is the strongest area of ESG incorporation by equities managers.
- Collective activity appears the sub-area where Frontier believes equities managers need to advance the most in terms of their ESG credentials.

- Frontier's recommended equities managers are scoring 3.38 ESG stars on average, so above the broader investment manager community. This is not a surprising outcome as Frontier believes in the merits of responsible investment and has a skew to the managers with stronger ESG credentials than the broader industry.
- Small caps managers (whether Australian or global) have, thus far, scored notably lower on ESG compared to broad caps managers. We rationalise this outcome on the basis these strategies are often proportionately more lowly resourced relative to those offering broad cap strategies.
- Frontier has found its emerging markets managers have scored higher than Australian equities and global equities managers. This finding appears mostly about Frontier's manager selection process. Emerging markets equities is clearly an asset class where all three E, S & G factors lag the developed world and Frontier has skewed its manager selection to those managers with the strongest ESG credentials to navigate through the complex world of investing in emerging markets equities.



The final word



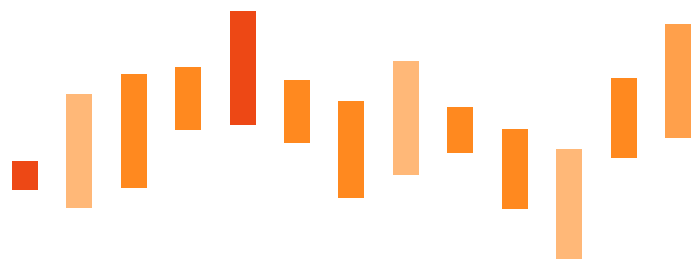
We think there are many important takeaways for clients with regards to equities managers and ESG.

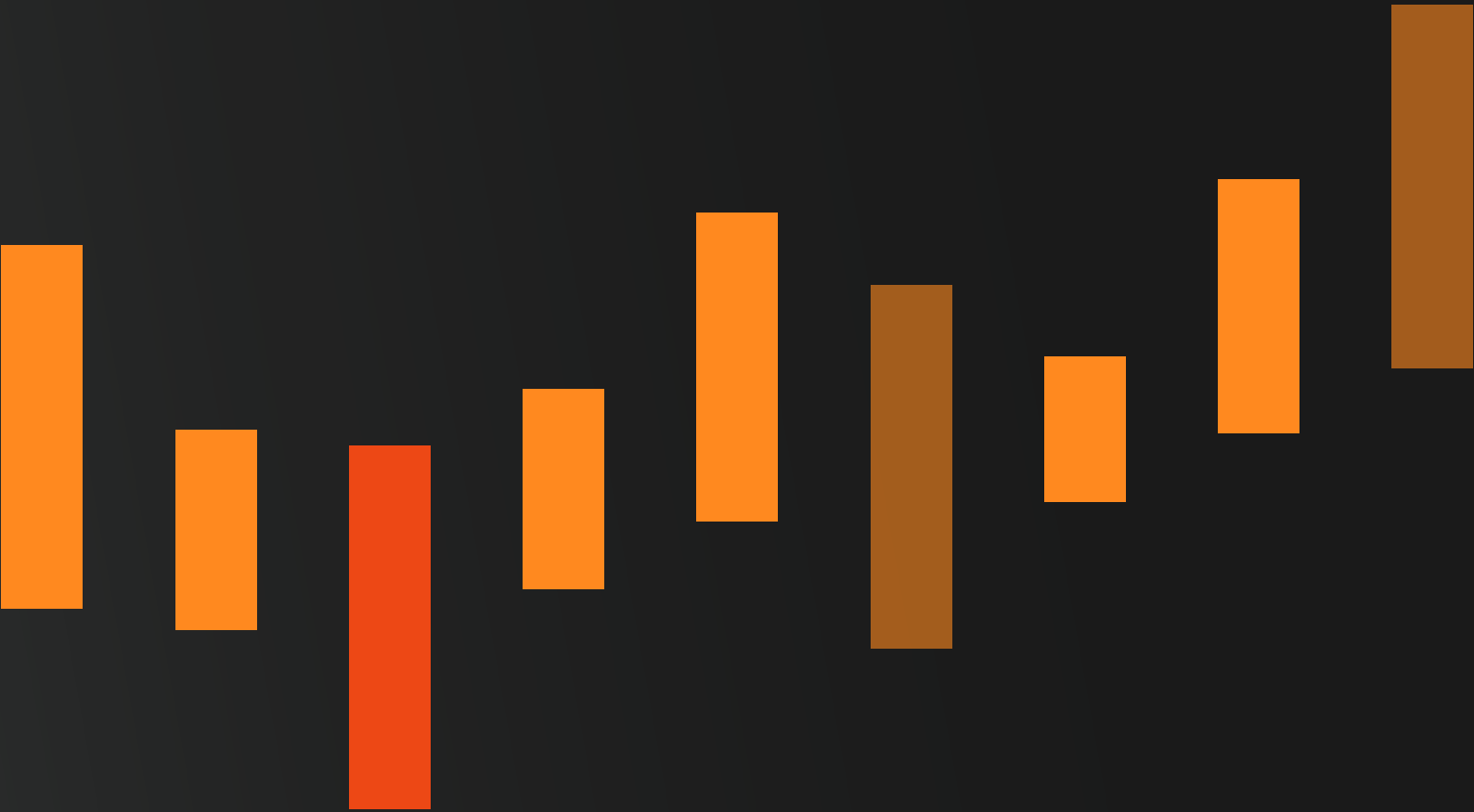
- Clients often use many different equities managers and the scores can be highly variable. The likelihood is that most asset owners will have some managers that need constant reminding to dedicate greater effort to advance their ESG efforts or run the risk of being terminated in favour of a competitor with a higher ESG rating.
- Small caps managers (both domestically and globally) should be challenged to keep improving as other equities sub-asset classes are more advanced.
- Passive managers are equally important in terms of their ESG assessment and clients should be holding their passive managers to account with regards to ESG incorporation.
- Collective activity is an area where equities managers can be doing more, so seems a sub-category for special attention. Frontier is highlighting this weakness to managers, but the scope for improvement is likely heightened if both Frontier and clients simultaneously make this point.
- ESG and climate-related reporting has improved in recent years but can be further improved.



Want to learn more?

Frontier's Responsible Investment Group, Equities Team and our other sector research teams would be happy to discuss our ESG scoring and assessments further.





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