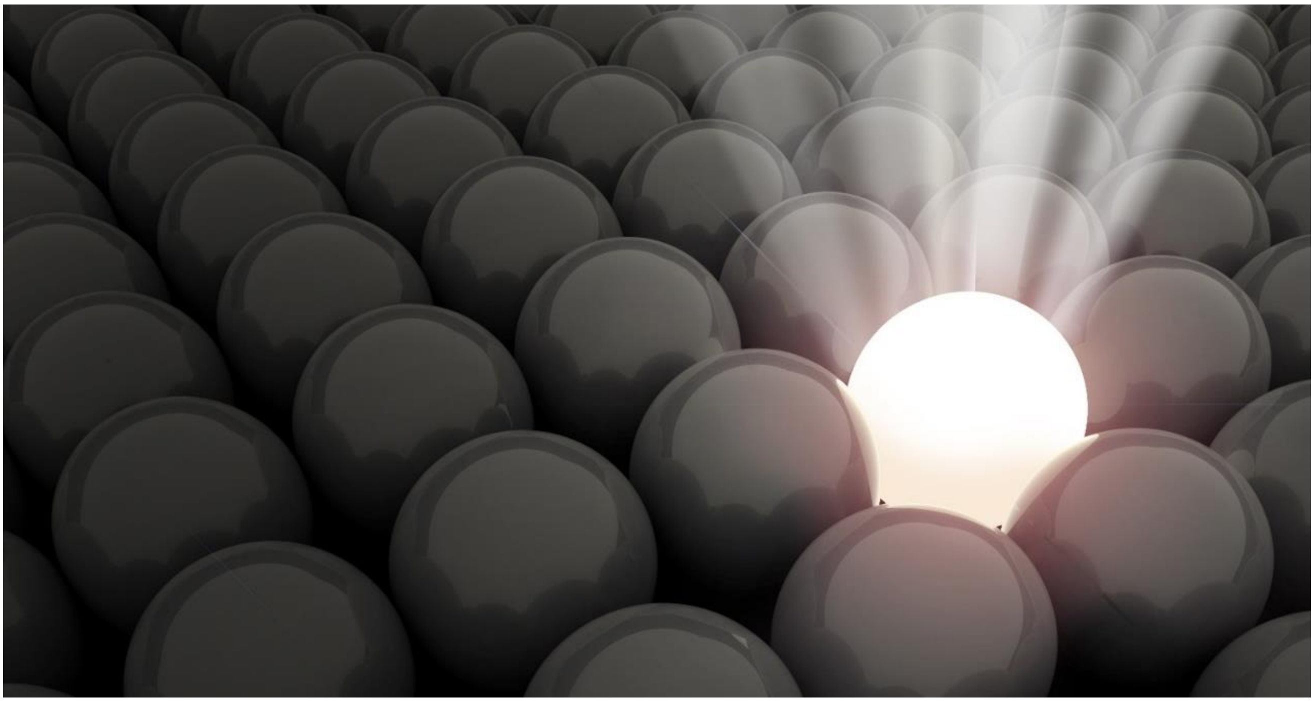
The Frontier Line

Thought leadership and insights from Frontier Advisors

Environmental, Social & Governance Survey

December 2013



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Introduction

Frontier Advisors recently conducted its fourth Environmental, Social and Governance (ESG) survey of both Australian and international equity fund managers (including emerging markets), to assess their attitudes toward ESG factors. The survey included a range of equity managers in regard to their investment style (e.g. value versus growth), size (large cap and small cap managers) as well as rated and unrated managers. We received 85 responses with 44 Australian equity managers and 41 fund managers with products in international equity and emerging market sectors. We note that the manager response rate was consistent with our 2011 ESG survey.

This report outlines the key themes and trends we have identified from the survey results.

Key themes

The results of the 2013 ESG survey, along with the analysis we have undertaken in previous surveys, have identified six key themes regarding the attitudes of equity managers to ESG issues today.

Managers believe ESG issues are relevant to future performance of companies.

Consistent with our previous survey results, the majority of managers (both Australian and global) continue to believe ESG factors have a meaningful impact on the future performance of the companies they analyse.

This is shown in Chart 1 along with the proportion of managers that have a formal ESG policy in place. It is interesting to note although the common belief among managers is there is a strong link between ESG issues and stock returns, fewer managers have a formal ESG policy in place, insofar as it affects their investment decisions.

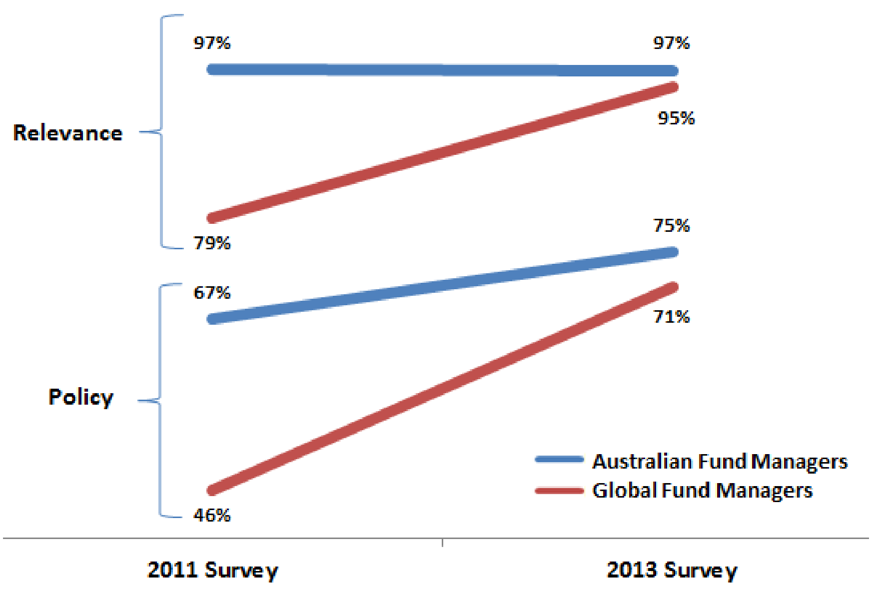
The number of managers with a formal ESG policy in place has increased significantly for global managers with an increase of around 25% from the 2011 survey results.

Decision making is impacted if ESG issues are deemed to be material.

A distinct theme which emerged from our results was in relation to materiality. The majority of managers, both Australian based and global, noted that ESG issues are taken into consideration when they are viewed to have a material bearing on the company's business and valuation. This is consistent with our previous survey results.

Managers rate companies based on their performance on each of the ESG factors and also on the materiality of the ESG criteria to the valuation of the company.

Chart 1: ESG factors have a meaningful impact on companies



Key themes

ESG factors are difficult to quantify.

Our survey results found that quantitative managers had a more difficult time finding suitable robust statistical factors when it came to ESG issues with one quant manager stating that “We are currently very close to incorporating some governance based signals in our strategies but do not currently have any actively traded ESG factors.” Our results show that for the majority of managers, ESG considerations are explicitly factored in to the Analysts’ qualitative research. Assessment of ESG related risks is usually undertaken on a case by case basis with the approach largely qualitative in nature.

Managers also noted that while qualitative factors (such as ESG issues) are difficult to value, they consider these factors as contributing to the likelihood of both future financial success for a business as well as the inherent risks, and as such, ESG factors often impact the size of the position.

Having said that, we found that a smaller proportion apply quantitative approaches and, where appropriate, include valuation impacts of ESG issues. For example, one such manager incorporated the value of environmental liabilities in its valuation of Orica and an estimate for the hacking liabilities in its valuation of News Corp.

Key themes

Managers continue to engage with companies on governance issues.

The majority of managers, both Australian based and global, believe that the Governance of a company is a vital component of the company's success and therefore this issue is looked at in the most detail among ESG factors during the investment process. While managers do appear to consider Environmental and Social issues at times, it doesn't appear to be to the same degree and may be a result of those issues being much longer burn issues and harder to quantify.

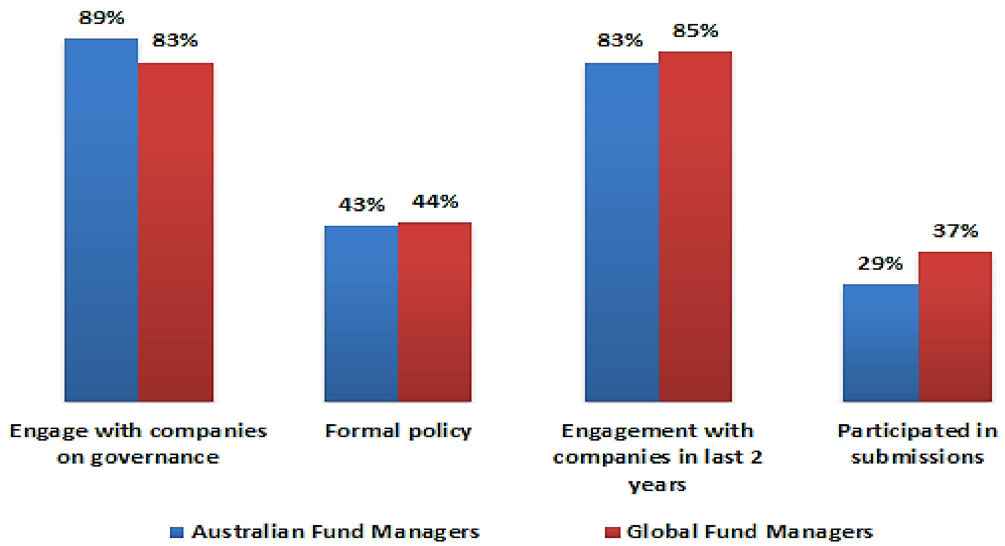
Most of the Australian and global equity managers surveyed claim to engage with companies when it comes to Governance related issues which is consistent with our findings from the previous surveys. Additionally, the engagement is led by the Analyst responsible for the stock, with a common response from managers (both Australian and global) that Analysts are expected to acquire a deep understanding of a company and gain good access to the management team. Engagement is typically face to face or via phone with management and/or board, although some managers have noted that some situations have warranted a more formal approach such as letters to the board etc.

Consistent with these findings is that a large proportion of managers have engaged with companies in the last two years, however we note that many managers do not currently formally track the number of companies with which they have engaged, nor the nature or results of the engagement.

Although engagement with companies is considered important by the equity managers surveyed, a much smaller proportion have a formal policy in place in relation to engagement with companies, preferring to raise issues during the course of normal management meetings and on ad hoc occasions should the need arise.

A small proportion of managers surveyed have participated in submissions on changes to corporate law or other standards that have a bearing on corporate governance. Although this number has increased since the previous survey results, it remains low at less than half the managers surveyed. Of the managers that do participate, this is generally via industry working groups such as ACI (Australasian Compliance Institute – an industry body for the practice of compliance, risk and governance in the Asia Pacific region).

Chart 2: Engagement around governance issues



Key themes

While managers believe ESG to be an important factor in stock analysis, it is not the most important factor.

While the majority of Australian and global equity managers take ESG issues into account at the stock or portfolio construction level, it is clear from our responses that it is not viewed as the most important factor.

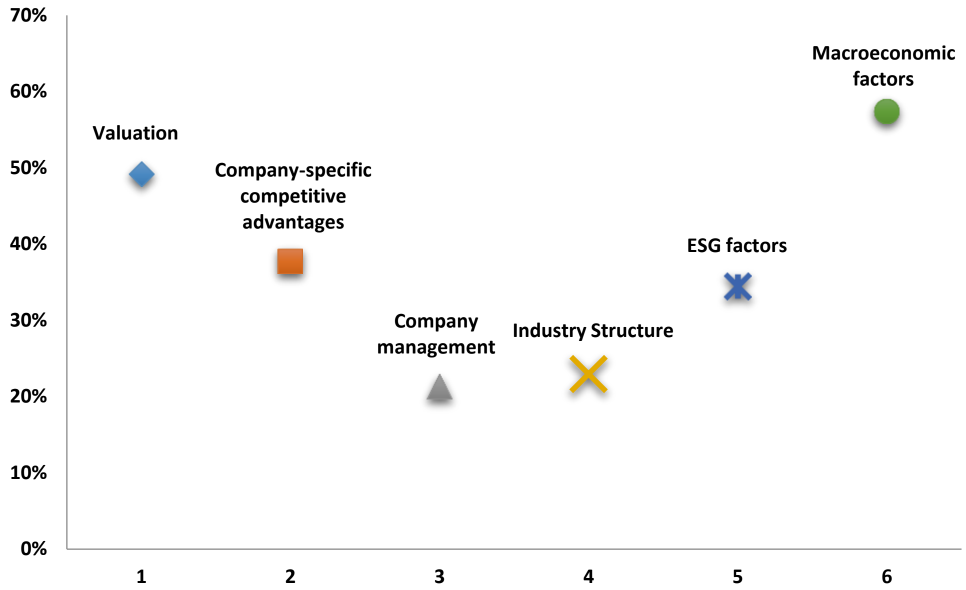
We asked managers to rank the importance of ESG factors compared to other common drivers of valuation, and the results can be seen in Chart 3.

We note that a number of managers surveyed chose not to answer this question, which could be due to managers treating ESG issues on more of a qualitative basis within their investment decision making process, making it difficult for them to quantify their response.

Of the managers who did respond, it shows that in aggregate for both Australian and global equity managers, ESG factors were ranked fifth out of the possible six factors. This is consistent with our previous survey results for global equity managers. Previously, Australian equity managers had ranked ESG factors third. It is important to note that the ranking of these factors will to some degree depend on whether a manager adopts a top-down or bottom-up approach to portfolio construction. Our sample may be biased as the majority of managers surveyed use a bottom up approach and therefore will commonly rank valuation ahead of macroeconomic factors.

The results show that while managers perceive ESG factors as a part of their wider investment analysis of a company, they do not view these factors as the most significant and consideration must also be given to other factors.

Chart 3: Importance of ESG factors



Note: Respondents ranked 6 factors from 1 to 6 to reflect their importance in stock analysis. Rank 1 represents the most important factor and rank 6 the least important factor. The vertical axis represents the percentage of managers who ranked the factor within each ranking i.e. 49.2% of managers ranked the Valuation factor as 1.

Key themes

More Australian equity managers direct brokerage in order to access ESG research.

While the use of brokers, and other researchers for ESG research has remained fairly constant, a significantly larger proportion of Australian equity managers specifically direct brokerage in order to access ESG research. This can be seen in Chart 4.

One such Manager sets aside a certain percentage of brokerage to encourage/reward brokers for specific ESG research or services which it believes adds value.

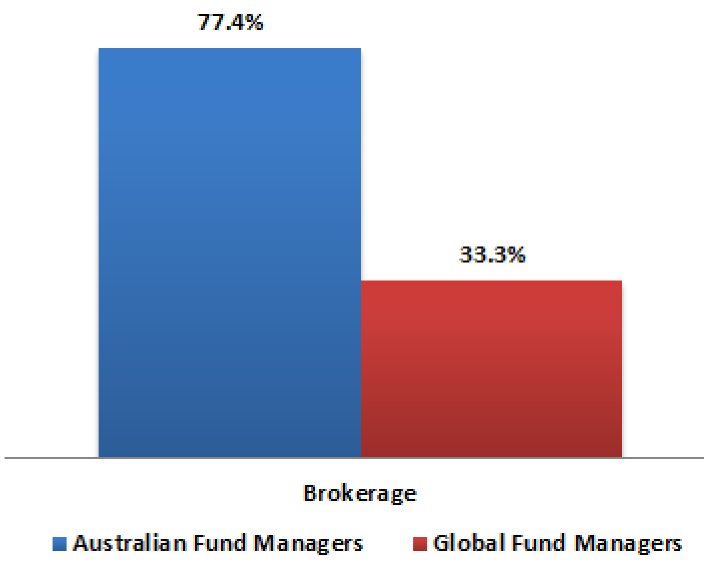
Generally, such brokerage is allocated by the ESG research team based on criteria including report quality, timely service/responsiveness and ESG insights, and facilitation of company contact.

The team will also discuss ESG topics with brokers to assist them in their own understanding and analysis of key ESG issues and themes.

Another Manager stated it does incentivise and reward broker research through the broker voting system. Its ESG Specialist is allocated a specific number of votes each quarter to assign to ESG broker research.

Another Australian equity manager engages international institutional stockbrokers who are active in ESG research, as well as rating all brokers on their ESG research via a discrete item in its broker rating matrix. This rating feeds into an overall score, which then serves to guide the allocation of trades (and hence brokerage).

Chart 4: Direct brokerage to access ESG research



Trends

The results of the 2013 ESG survey have identified the following trends.

An increasing number of managers have signed the PRI

It is pleasing to see an increase in the proportion of both Australian and global equity managers that have signed the PRI as can be seen in Chart 5.

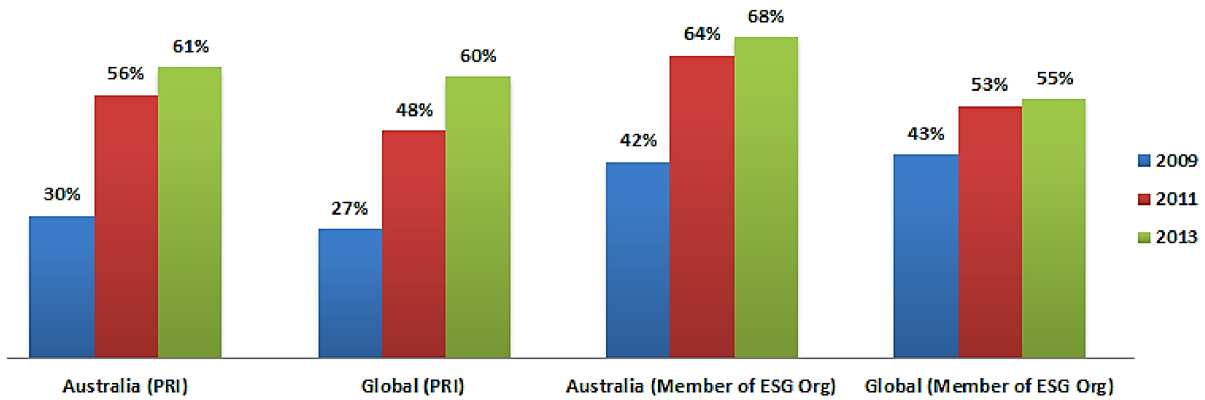
What is more interesting is why managers are choosing not to sign the PRI. While most managers are generally supportive of the PRI principles and supportive of the overall philosophy, some believe the principles are currently set out in very general terms.

Others who have not signed it, believe they have incorporated similar beliefs into their investment process already and therefore there is no need to sign it.

One manager stated, “we see little value in being a signatory as this would not impose any additional obligations on us”.

Similarly another stated “we believe we incorporate ESG issues into our investment analysis and decision-making process and demonstrate a commitment to active ownership through our engagement and voting practices consistent with the PRI.”

Chart 5: PRI signatories and Member of ESG Organisation



Trends

The inclusion of internal ESG specialists has increased for global equity managers.

The survey results show the majority of equity managers (both Australian and global) incorporate ESG analysis during the research level. What is more interesting is the number of Australian based equity managers who have assigned a specialist team to analyse ESG issues has decreased, preferring for the responsibility to be predominantly that of the research Analyst. This contrasts with the results for global equity managers, who are increasingly more likely to allocate the ESG analysis to a specialist team.

One global equity manager maintains a permanent in-house team of six governance specialists who form part of the equity investment team. Members of this team generally serve as internal leaders in the area of ESG to help set up ESG policies and serve as resources to the investment team globally.

In other cases for global equity managers, we found that although the Analysts have the overall responsibility for analysing the ESG performance of the companies they research, the Manager also has a dedicated Global ESG Specialist.

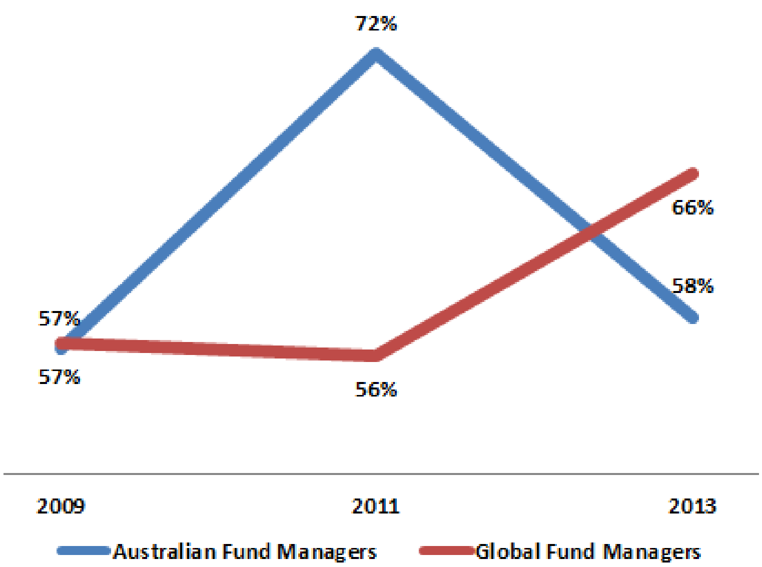
This individual works closely with both the equity and fixed income investment management teams and coordinates ESG training with the Directors and Heads of Research.

Another global equity manager has a Corporate Governance team consisting of six Analysts who are responsible for co-ordinating the ESG research. It is the Corporate Governance team's responsibility to communicate with the investment managers when any new corporate governance, environmental or social concerns arise. The Corporate Governance Team sits alongside the investment teams and each member for the team is responsible for liaising with specific investment teams.

Chart 6 shows since the last survey in 2011, the inclusion of internal specialists for Australian based managers has decreased, whereas it has increased for global managers.

We don't see this decrease as necessarily a negative but rather a change in the way managers treat ESG issues in Australia. While our results show global managers are making progress with an increase in the use of internal specialists, in Australia, this is evolving further and advancing such that the research Analyst has essentially become the internal specialist.

Chart 6: Internal specialists



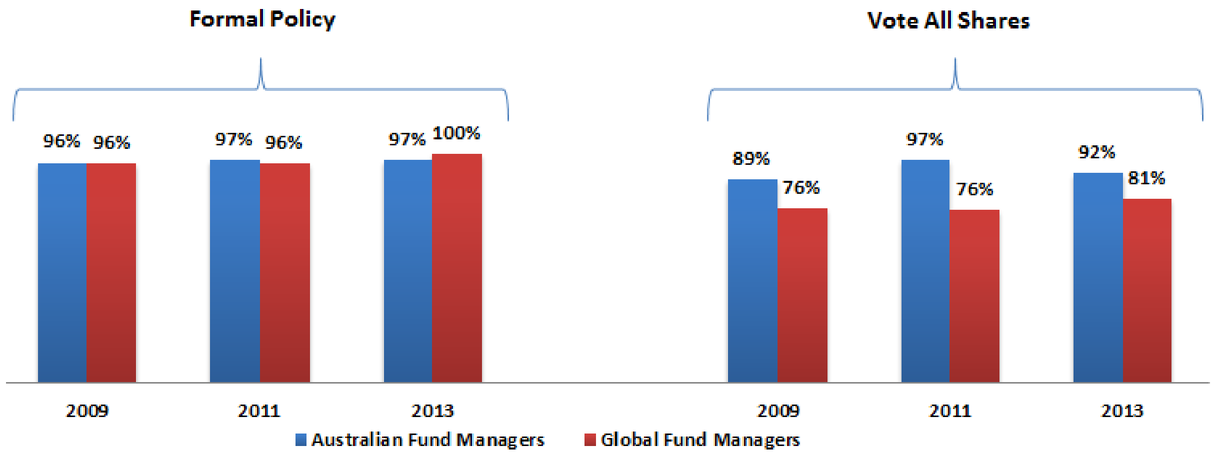
Trends

A greater proportion of global managers now voting all shares.

The survey results show that the majority of equity managers continue to have formal policies in place governing proxy voting as can be seen in Chart 7 and is consistent with the previous survey results.

Previously, a significantly larger proportion of Australian equity managers chose to vote all shares, which did not translate into the same level of activity in exercising voting rights for global equity managers. This was in part linked to various “share blocking” laws in effect across the international equities space. However, the most recent survey results show that this has changed with around 80% of global managers surveyed choosing to vote all shares.

Chart 7: Voting policies



Conclusions

Our 2013 survey results show that as attitudes toward ESG issues continue to grow in prominence so too has their incorporation into the investment decision making process. The overall quality of responses from the equity managers surveyed has improved from our previous survey with the majority of managers (both Australian and global) providing thorough and comprehensive responses.

In conducting this research we found both Australian and global equity managers believe ESG factors have a meaningful impact on the future performance of the companies they analyse.

It is pleasing to see an increasing number of managers have now signed the PRI and a greater proportion of global managers are now voting all shares (this has remained high for Australian equity managers).

Additionally, the majority of managers incorporate ESG factors during the stock research process within their investment process.

In general terms, ESG factors are taken into consideration when they are deemed to have a material impact on a company's business and valuation and are generally considered on a qualitative basis.

A distinction between Australian and global equity managers was in regard to internal specialists, where our results showed that in general terms, the proportion of Australian equity managers who have a dedicated ESG specialist has decreased since the 2011 survey, with these managers allocating the ESG analysis to the Analyst responsible for coverage of the company.

This is compared to the global equity managers surveyed, who have increased the use of dedicated ESG specialists.

This is not necessarily a negative but rather shows how the treatment of ESG related issues are further evolving, such that the research Analyst here in Australia has essentially become the internal specialist.

In general terms, Governance factors are considered to be the most significant and managers continue to engage with companies on Governance issues.

We also found while managers believe ESG issues to be an important consideration in stock analysis, it is not the most important factor.

Another clear distinction between Australian equity managers and global equity managers was in relation to brokerage, with a significantly larger proportion of Australian equity managers specifically directing brokerage in order to access ESG research.

Frontier Advisors continues to be pleased with the progress equity managers have made in the area of ESG since our first survey in 2007.

Going forward, we will continue to engage with managers in regard to their views and attitudes toward ESG issues and in particular, how this has translated into the way they analyse companies, make decisions and construct portfolios.

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