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Beyond stock selection

A bigger ESG toolkit for equity investors

FRONTIER ADVISORS

Frontier Advisors

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Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.

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Beyond stock selection: A bigger ESG toolkit for equity investors

Consideration of environmental, social and governance (ESG) factors by institutional investors continues to grow in prominence. The last few years have seen a sizeable shift in the investment industry's approach to more actively incorporating analysis of ESG factors into investment processes. There is increasing demand for genuine long-term investing, taking a more holistic perspective of responsible and sustainable fiduciary duties.

Frontier views ESG integration in equities as a significant investment consideration given the size of the asset class and the allocation within client portfolios. The equities asset class has historically been at the forefront of ESG integration. The public nature of underlying portfolio holdings, the ability to exercise voting rights and often vast opportunities to engage with management makes the asset class a natural focal point for the implementation of an ESG-integrated investment approach. This paper provides an overview of what Frontier views as best practice in regard to integrating ESG into equity investing.

Beyond the basic premise that equity investors and their investment managers should integrate ESG factors in their investment process, we focus on the broader range of responsible investment tools available to active equity owners in order to influence a company in appropriately and adequately addressing ESG issues. We explore the ESG challenges around investors relying on divestment/ exclusionary strategies. Finally, we also outline what Frontier considers when assessing Equities managers with respect to ESG.

Active ownership

ESG best practice in equity markets goes beyond the assessment and integration of ESG factors into the investment process. Active ownership (also known as stewardship) is generally regarded as one of the most effective mechanisms to reduce risks, maximise returns and have a positive impact on society and the environment. It typically involves investors exercising their proxy voting rights and using their influence to drive better outcomes through engagement efforts. Active ownership is one of the fastest-growing responsible investment strategies in listed equities globally.

It applies to all investment styles including active and passive management and all asset classes including Australian and international equities. Even for a passive manager, active ownership represents a tangible way in which a manager can positively impact the value of the underlying holdings. Passive managers are able to use their size and influence to gain corporate access and allow them to establish and maintain an open and constructive dialogue with company management and boards

Engagement

Pleasingly, recent PRI data shows that active engagement practices are becoming increasingly common among investors, with only 11% of signatories reporting zero dialogue on ESG issues with listed equity companies in their portfolios.

Asset owners can engage with companies on three levels:

1. Direct engagement;
2. Collaborative engagement (may include asset owners and investment managers and is unlikely to be the sole method of engagement); and
3. Outsourced engagement:
    - Carried out by an investment manager (who may sub-contract to service providers); or
    - Carried out by a specialist service provider (directly contracted by an asset owner).

Importantly, engagement builds on relationships over time and creates more effective dialogue going forward. It provides access to and sourcing of relevant ESG data (which may not otherwise be readily available) and allows investors to clarify publicly-available information.

It also means that investors are able to gain insight into how a company is positioned to mitigate risks or leverage opportunities stemming from ESG factors going forward. Engagement promotes change and can positively influence how an issuer is managing particular ESG factors and/or issues.

Proxy voting

Engagement and voting practices are interlinked and feed into each other. Share voting is an important tool for engaging with companies. It allows investors to voice their view to company management, particularly around board composition and executive remuneration. Not only are more institutional investors actively exercising their proxy rights in recent years, we have observed a greater willingness to vote against management proposals where these are not deemed to be in the best interests of shareholders.

When assessing the quality of ESG-related resolutions presented at AGMs, investors need to consider:

- the topic;
- the invitation for leadership;
- the evidence;
- current performance;
- previous engagement;
- the tone;
- the suggested timeline;
- external pressure; and
- disclosure requests.

Beyond research and casting votes, voting involves communicating with companies before and after the AGM. Investors should raise concerns with companies before voting against (or abstain) in order to initiate dialogue and receive additional information. This empowers investors to shape corporate behaviour.

Both engagement and proxy voting are typically aimed at driving positive change within a longer-term context. Frontier considers it best practice for active ownership outcomes to be measured over time to determine how successful such efforts have been in creating tangible shareholder value. Should management be demonstrably poor in addressing investor concerns around ESG over a sufficient period of time, it could influence the decision on whether to retain the position in the portfolio.

Divestment/exclusions

Historically, divestment or exclusion strategies have been a popular way for investors to manage certain ESG risks. Faith and/or ethically-based investors with strict values-based investment strategies will often be required to avoid exposure to specific stocks.

Frontier acknowledges that in some cases, divestment/exclusions on ESG grounds may be the most appropriate (investment in certain companies is assessed to be damaging from a financial, reputational or ethical perspective).

In more recent times, more investors are thinking about carbon divestment in order to mitigate carbon risks and better manage the transition to a low-carbon economy. However, given that ESG analysis identifies both risks and opportunities, it is important to note that an approach which excludes particular stocks/countries/sectors/themes runs the risk of neglecting certain potential improvements or opportunities that may add value. Indeed, according to the PRI, divestment alone leaves investors with no voice and no potential to help drive responsible corporate practices. Understandably, company management will typically be less inclined to engage with non-shareholders on ESG issues. As such, we encourage investors to consider the possibilities of active ownership as noted above, if there is no formal compulsion to formally screen out a particular investment.

Sustainable development goals

In September 2015, the UN released its 2030 Agenda for Sustainable Development with its 17 Sustainable Development Goals (SDGs) and 169 targets. The SDGs provide a broad universal framework for future developments in various fields including public policy, corporate governance and investment management.

Frontier is considering active investment opportunities in the context of the SDGs as well as engagement and portfolio risk assessment. We intend to focus on a number of SDGs, such as Gender Equality and Clean Energy, where we believe we can have an influence. In a number of examples the SDGs are interrelated and our focus list does not preclude us looking at other areas in the future. Our future ESG initiatives will generally be referenced through the SDG framework.

To prepare for the SDGs, companies and investors will have to take a number of steps.

1. Determine the extent of their exposures to the SDGs that are most relevant to their businesses;
2. Set specific goals for contributing to the most relevant and material SDGs (i.e. reflect specific goals in incentives through the use of metrics, or key performance indicators (KPIs);
3. Establish a system for measuring and reporting on contributions to the SDGs.

Although companies are increasingly referring to the SDGs in their investor communications, corporate discussion of targets and KPIs on SDGs remains in its infancy. We believe this will evolve in the future as investors' expectations change and develop.

Frontier's assessment: The consideration of equity managers

When assessing managers, Frontier's efforts to date have been focussed around drawing attention to ESG and emphasising its importance at both the firm and investment level. More importantly, we focus on the strength of the Manager's ESG culture and the manner in which ESG is integrated into the process.

Responsible investment practices viewed as best in class for equity managers include:

- Regular cross-team meetings and presentations (e.g. between investment and ESG teams);
- Share active ownership data across platforms that is accessible to ESG and investment teams;
- Encourage ESG and investment teams to join engagement meetings and roadshows;
- Involve Portfolio Managers when defining an engagement programme and developing voting decisions;
- Establish mechanisms to rebalance portfolio holdings based on levels of interaction and outcomes of engagements and voting; and
- Consider active ownership as a mechanism to assess potential future investments

Our primary objective

Fundamentally, our primary objective is to learn more about the degree of integration of ESG considerations within the manager's culture.

As part of Frontier's assessment of Managers, we focus on the Managers' integration of ESG across areas such as their philosophy, culture, research, risk, and portfolio construction. Questions/considerations may include:

- Does the Manager have a formal ESG policy in place?
- The Manager's ESG policy should not be taken on face value. Simply being a PRI signatory is no longer considered sufficient or even a material factor.
- The Manager's actual motivations and level of adherence to the policy needs to be tested. Does the Manager genuinely believe that ESG integration is important?
- Does the Manager integrate its ESG assessment as part of its overall assessment of the company, are ESG insights considered alongside the Manger's fundamental analysis or is ESG considered on ad hoc basis?
- How is the Manager ranking the individual ESG factors, what weighting is placed on the various sub-factors considered?
- How does the resulting ranking influence an investment decision?
- Does the Manager exclude certain countries/sectors/themes from the investment universe due to a poor ESG score or is an ESG overlay applied where it over or underweights securities relative to the benchmark based on the ESG score?
- If the Manager excludes a particular a country/sector/theme, what are the practicalities of doing so, particularly if it comprises a significant allocation within the index (i.e. impact on tracking error)?
- Is the Manager able to demonstrate examples of engagement which have influenced investment decisions?
- Is the Manager able to demonstrate and report on various portfolio level ESG metrics like carbon intensity etc.?
- Does the Manager consider ESG risks alongside other factor risks when constructing/monitoring portfolios?

Understanding fund managers

In addition, as part of our manager due diligence process, we now ask fund managers about the diversity of their investment teams. There is a growing body of evidence to support the case that equity managers with diverse investment teams benefit from more robust decision-making processes. We are seeking to understand how each manager views diversity and what initiatives (if any) they have in place to promote diversity. We have started gathering data on the diversity of investment teams and are including an assessment of diversity in our Manager Assessment Profile Summary documents (MAPS). Going forward, we will use our data and results to form a basis for continued benchmarking of organisations on their progress to improve diversity of their investment teams.

Managing ESG in an equities portfolio

Investors looking at ways to better manage ESG risks and opportunities within the equities sector could consider the suggested steps below.

Establish responsible investing beliefs

Consider investment beliefs around ESG issues (what is important? what is your risk tolerance toward the risks that ESG issues pose?).

Document investment beliefs (guidelines) around ESG investing, the level of ESG integration to be targeted and your risk attitude around ESG issues.

Considering active investment opportunities within equities, engagement and portfolio risk assessment in the context of the SDGs .

Consider implementing a Responsible Investing Policy to provide a robust framework to assess Manager ESG integration.

Portfolio construction

Consider ESG issues in the structure and diversification of the equities Portfolio and in the allocation of assets within asset classes.

Identify and consider key ESG risks (climate change) within the equities Portfolio and across the total Portfolio.

Consider most appropriate way to integrate ESG in the equities Portfolio. Does this include engagement, voting all proxies or divestment/exclusions? What should we invest in, what should we avoid?

Engage with companies directly, alongside Managers, or encourage collaborative engagement between existing Managers on specific ESG related issues.

Discuss with managers about how they think about SDGs in their research.

Seek appropriate disclosure on ESG issues by the entities in which invested.

Manager monitoring

Assess how ESG has been integrated across the equities Portfolio and total Portfolio versus the investment beliefs and ESG objectives.

Annual ESG health check of Managers, following up on any suggested areas of improvements.

Benchmarking of existing Managers versus broader Managers
to ensure best practice is maintained over time.

Continue to engage and collaborate with existing Managers.

Review and revise investment beliefs regarding ESG integration (including risk tolerance) and Responsible Investing Policy on an ongoing basis.

The final word...

As the focus on ESG by investors has intensified, so too have our views around how ESG should be incorporated into a portfolio. Frontier believes that ESG factors should be considered at the aggregate portfolio level and integrated through the investment process. We believe active ownership is a powerful tool achieved by engagement and voting which allows investors to have a voice and can bring about change.

Today, consideration of ESG issues is much beyond a box ticking exercise. ESG factors must be demonstrably embedded in the firmwide culture of an organisation and filtered down to the rest of the group.

ESG integration is a continually evolving aspect of equity investing and best practice requires Managers, and investors alike, to evaluate their philosophy and process and make enhancements on an ongoing basis.

Frontier views the assessment of ESG factors within equity markets as an important and evolving area of research. We will continue to enhance our approach to identify and assess ESG risks and opportunities within our equities manager research process. Frontier 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.