

PRI webinar: Unraveling the relationship between ESG factors and investment performance

14 JANUARY 2012

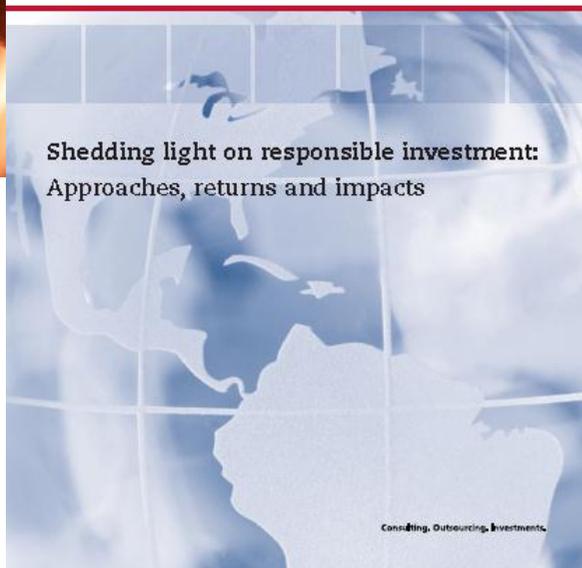
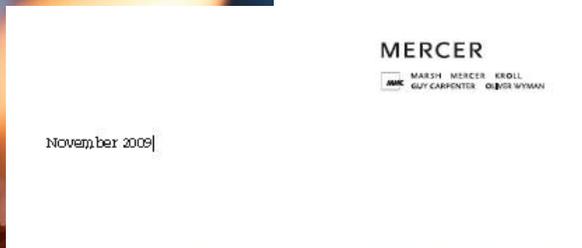
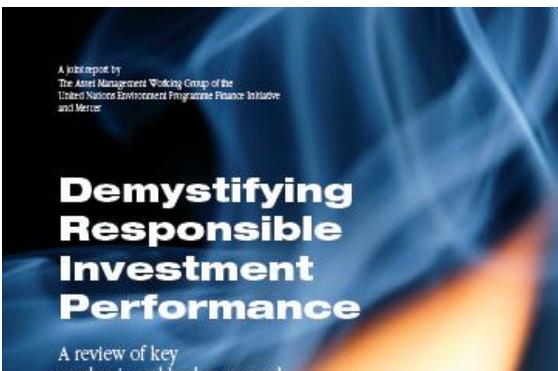
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A new era of investing

- ESG factors are playing an increasingly important role for global fiduciaries
- Markers of this change include:
 - Growth of support for the Principles for Responsible Investment
 - Growth in tools, research and standards for integrating ESG factors into investment decisions
- A growing body of academic and industry literature suggesting that;
 - ESG factors can impact investment performance and risk, and
 - Looking ahead, ESG factors will become increasingly material
- Academic interest in the field is growing, but pioneering research has been produced by practitioners
 - Prequin's research in private equity, Colonial First State's research in infrastructure

Overview of studies



Meta-reports (2007 – 2009)

- 20 of the 36 studies reviewed showed a positive relationship between ESG factors and financial performance
- 11 found a neutral link
- 5 found a negative link (mostly all testing the impact of negative screening)

Additional research (2009 – 2011)

- A number of more recent studies show a positive relationship across asset classes
- We expect literature to become more robust and rigorous as the industry progresses

Assessing the evidence

- It is a misconception to assume RI leads to financial underperformance
 - The evidence shows that there is not a performance penalty but it is not clear cut support of investment case
- Far more studies on corporate governance and screening exist than on other aspects of RI, including ESG integration
 - Case for active ownership is strong
- The usefulness of ESG information varies by region, sector, and over time
- Various factors such as manager skill, investment style and time period are influential
- RI can be successfully implemented in any investment style
- Observations about research approaches:
 - Genuine ESG analysis needs to be distinguished from simple automatic exclusions
 - Systematic translation of ESG factors into quantitative inputs and financial ratios still in development

MERCER'S ESG RATINGS

Mercer's ESG ratings – what do they mean?

- Since 2008, ESG ratings have been assigned as part of our core manager research process to provide an indicative assessment of how managers perform in this area. Separate rating allows clients to assess or track managers
- Comprehensive ESG Research Notes assess and document a manager's approach to ESG analysis and stewardship
- See <http://www.mercer.com/articles/ESG-ratings-update> for more information

ESG1

- Strong evidence of ESG integration into investment ideas, active positions, voting and engagement and firm-wide collaboration

ESG2

- As per ESG1 but may not meet highest standards across all criteria, e.g. weaker on active ownership or less evidence of ESG into idea generation and/or risk assessment

ESG3

- Broad awareness and most likely strong on G issues but weaker on E and S and not an active participant in collaborative initiatives

ESG4

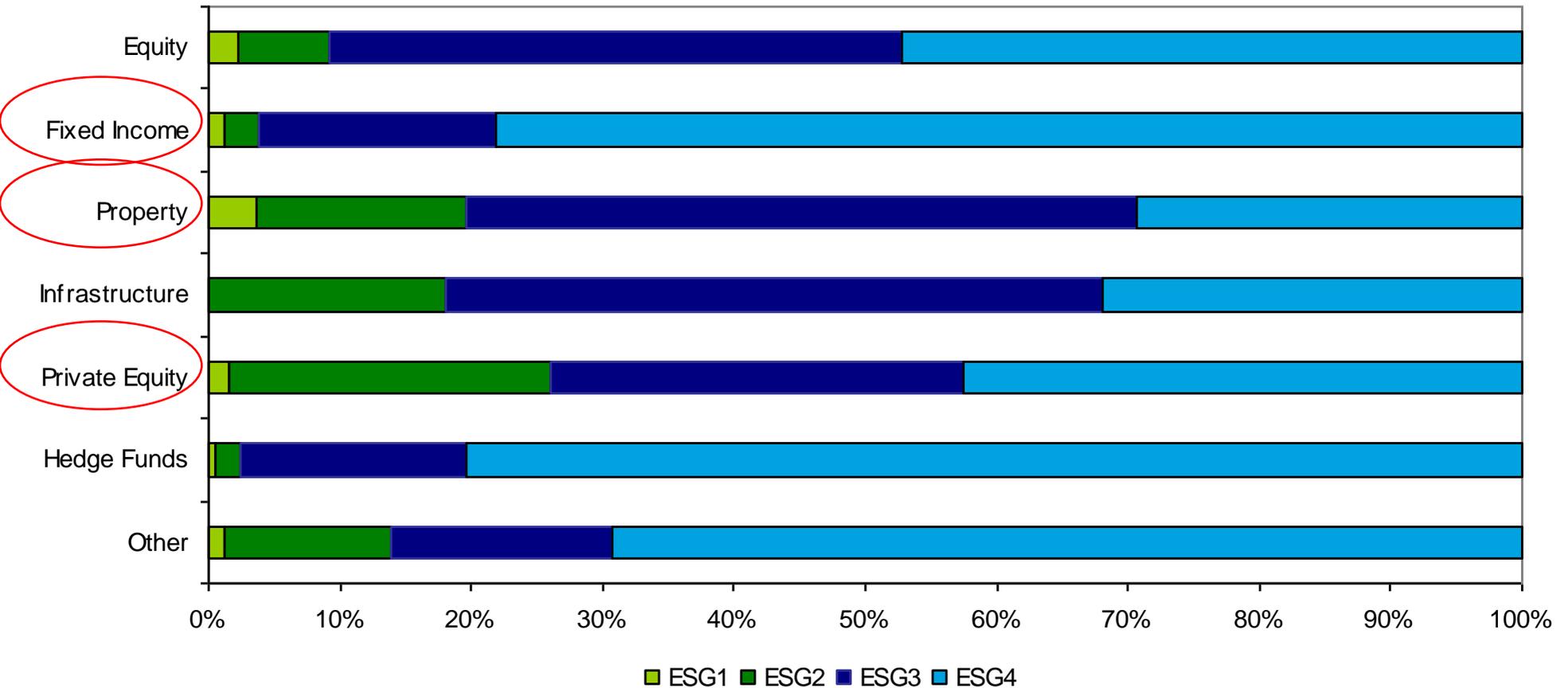
- Little or no evidence of ESG integration into core processes and no clear indication of future change or plans

ESG ratings across asset classes

9% of strategies rated are ESG1 or ESG2

n = 5,175

Distribution of ratings within asset classes

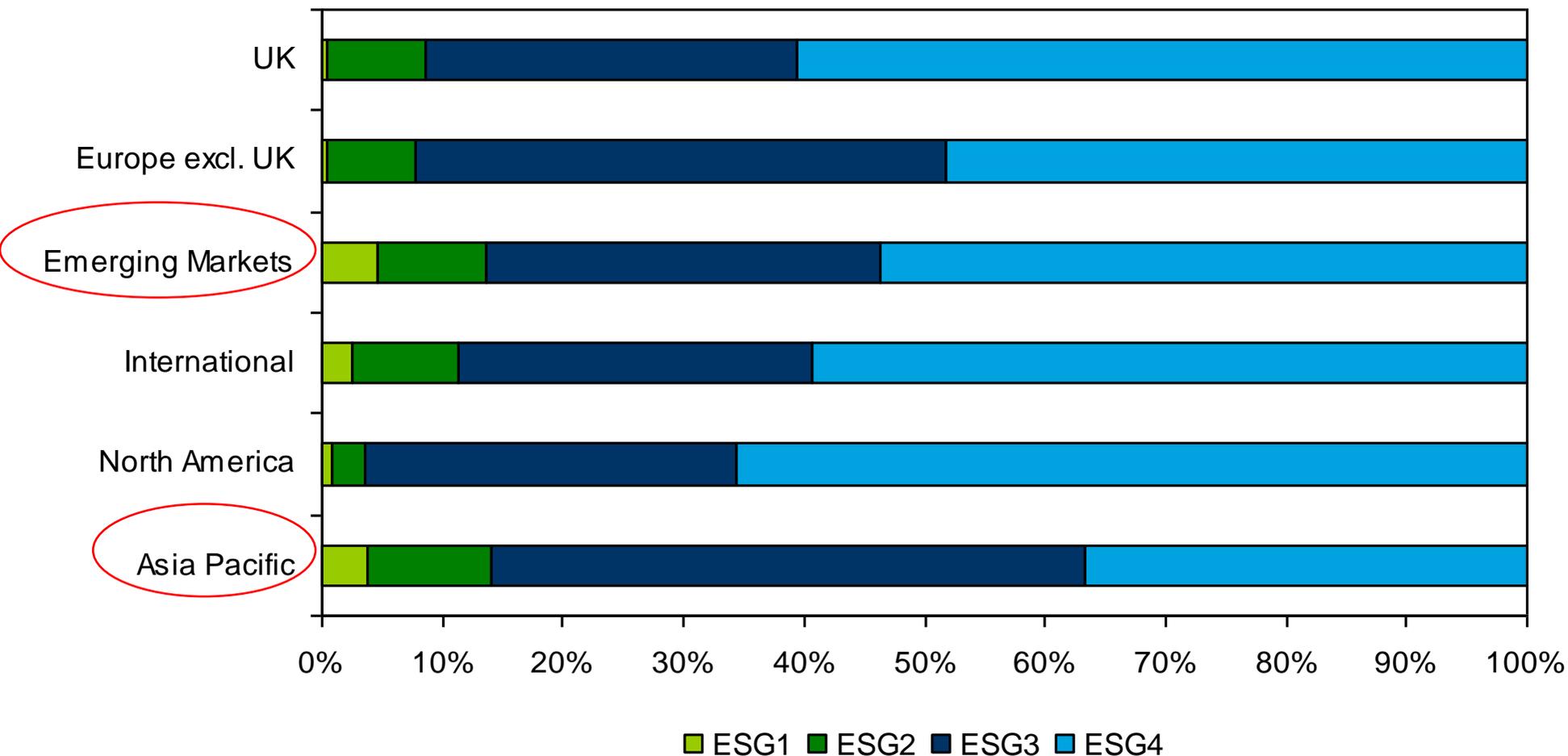


ESG ratings across regions

Emerging Markets and Asia-Pacific show leadership while North America continues to lag

Regional breakdown by ESG rating

n = 5,175



What are the leaders doing?

While practices vary, common features include...

- A demonstration that ESG factors feature in the natural course of the investment teams' **decision making process and corporate culture**
- An **effort made to build in some ESG factors into valuation metrics**, using their own judgment about materiality and time frames
 - ESG issues can assist in evaluation of management quality as well as business model (products, efficiency, human capital), cost of capital, future earnings, etc.
- A **long-term investment horizon and low portfolio turnover**, with some (preliminary) thought given to incentives for long-term behavior
- A voting and engagement policy and process in place that is moving towards being more **integrated, transparent and measurable**
- For alternative assets, evidence of **pursuing best practice standards on emerging governance, codes of conduct, etc. relevant to the asset class**
- Willingness to **collaborate** to redress systemic issues

Integrating ESG factors into investing – Challenges

- While ESG issues can be material, the challenge is establishing when and where
- ESG data is not as standardized as traditional financial data
- Solution is not necessarily separating the good performers from bad
 - Leading ESG performance can make a stock expensive and vice versa
 - Key is to integrate ESG and investment characteristics according to styles and asset classes
 - Informational inefficiency is an argument for rather than against integration
- Can be difficult to evaluate how managers view ESG and are incorporating it
- Diversity of approaches means its difficult to benchmark and track performance (although diversity of investment managers and styles means diversity in approach to ESG and lots of creativity and innovation)
- Few “pure” ESG integrated funds and limited track record to analyze ESG performance impact (our attempts are so far inconclusive)

We still see limited demand signals from asset owners – need to integrate ESG demands into RFPs, IMAs, monitoring and compensation arrangements.

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