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2018 ESG survey: How are managers integrating ESG?

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The importance of environmental, social and governance (ESG) factors within investing has increased exponentially over the last few years. As such, we've conducted an annual ESG survey of fixed income managers for some time now. However, this year we wanted to cast the net wider to include equity managers and gain a more holistic understanding of the market. Here we outline the survey's key trends and findings.

ESG manager survey: The what and the why

Integrating ESG

Targeted at asset managers of all sizes — from across all asset classes — we surveyed 299 firms to learn how they are integrating ESG considerations into their investment process. From this survey, we've observed a rapid growth in the awareness of ESG factors.[1] Crucially, this has fostered a widespread willingness among managers to incorporate ESG factors into their investment processes.

In this paper we present our results from across the board and put the spotlight on:

- Adoption of the Principles of Responsible Investment (UNPRI)
- Implementation of responsible investment policies
- Dedicated investment professionals
- Investment process — motivation, data and research

The results serve as an important reference point for our manager researchers to engage in further dialogue at regular due diligence meetings. ESG integration is an important consideration that we use when evaluating managers.

ESG means different things to different asset managers

One of the key points we've noted is that ESG consideration means different things to different people – there is no standard investment practice when it comes to ESG integration. Indeed, in our survey we've observed varying degrees and methods in regards to how managers integrate ESG factors into their investment practices. Below, we outline the three most typical ways that managers go about this:

1. **ESG within risk management**

In the past, the words *ESG* and *Responsible Investing* were primarily understood in terms of clients' ethical value judgements — and were often deemed as potential detriments to performance. However, an increasing number of the managers we surveyed have adapted their understanding of ESG and now see ESG factor assessment as an integral part of their risk management exercises. In our opinion, this makes sense, because capital appreciation opportunities are typically much more limited for bond investments than for stock investments — making downside management a crucial component of bond investing.

[1] Source for ESG survey: Russell Investments research

2. Integrating ESG data sets

One of the most prominent findings from our survey is that a large proportion of respondents have started to incorporate explicit ESG factors throughout their scoring methodology, while others have taken a more integrated approach. Some managers use their ESG scoring systems and data for companies or countries in which they invest.

Especially for fixed income managers, the ability to create independent ESG scoring methodologies and results has only become possible because of the increased availability of ESG-specific data for the fixed income market. ESG data providers have seen tremendous growth in the fixed income market over the past couple of years. We found that a large number of our survey respondents use these newer ESG-related data sets to distinguish and separate inputs into their investment decisions, while others have made these ESG data sets an important part of their overall screening process (for the companies they invest in).

3. ESG as a governance consideration

ESG factors encompass a broad range of topics, such as climate change, sustainability, human capital employee health and safety, corporate governance and so on. The results of our ESG survey have highlighted how managers treat the governance aspects of ESG. We've found that the environmental and social factors are often considered as external risks, or non-financial considerations where their direct impacts are less clear. We believe this is partially because of the challenges in assessing the impact of these *E* and *S* factors on security prices, given that many *E* and *S* factors may show up episodically — often observed in negative events.

For instance, safety practices for workers often becomes a forefront issue only when there is an accident. Conversely, when companies manage the *E* and *S* factors well, the precise financial connection with a ESG consideration is hard to make. We see money managers increasingly incorporating these so-called *non-financial* considerations as a part of their security analysis, in order to obtain a more comprehensive view of the company or investment they're making. In other words, many money managers appear to be treating ESG considerations as risk management exercises to protect and enhance the economic value of the companies they invest in.

UNPRI signatories and responsible investment policies

The UNPRI are a globally recognised benchmark that actively promote the implementation of responsible investment policies. Therefore, it was important to ascertain from our survey the extent to which managers across the globe have pledged to the UNPRI and developed a responsible investment policy. We found that the vast majority of our survey respondents are indeed UNPRI signatories and have adopted a responsible investment policy. That said, we found that this differs significantly across regions, time and assets under management (AUM).

Regional differences

As you can see in charts 1 and 2 (overleaf), firms based in the United States, Canada and Asia (excluding Japan) lag significantly behind peers from other regions. Even after factoring in the firms that intend to develop a responsible investment policy over the next 12 months (chart 2), firms from these countries still fall to the bottom of the pile.

UNPRI timeline

As you can see in This trend also aligns with the timeline by which these countries signed up to the UNPRI. Over 50% of respondents in North American regions (i.e., the U.S. and Canada) only became UNPRI signatories after 2015. Meanwhile, of all respondents, the majority of firms in Japan, Australia, New Zealand, the United Kingdom and continental Europe became UNPRI signatories prior to 2015. The number of UNPRI pledges has grown rapidly since 2006 and there is a clear relationship between the date of a firm's pledge, and the extent to which they have implemented responsible investment policies. This suggests to us that being a UNPRI signatory is now more of a hygiene factor, rather than a clear indication of actual ESG integration.

Adoption positively correlates with AUM

We also found that the prevalence of UNPRI signatories and responsible investment policies increases with the size of a firm's AUM. Per our survey, the percentage of firms that are UNPRI signatories with responsible investment policies is twice as high in firms with an AUM greater than $500 billion USD (versus firms with an AUM less than $10 billion USD). This is likely due to larger firms having the resources — and perhaps the financial incentive — to fulfil the responsibilities required to be a UNPRI signatory and to have detailed responsible investment policies.

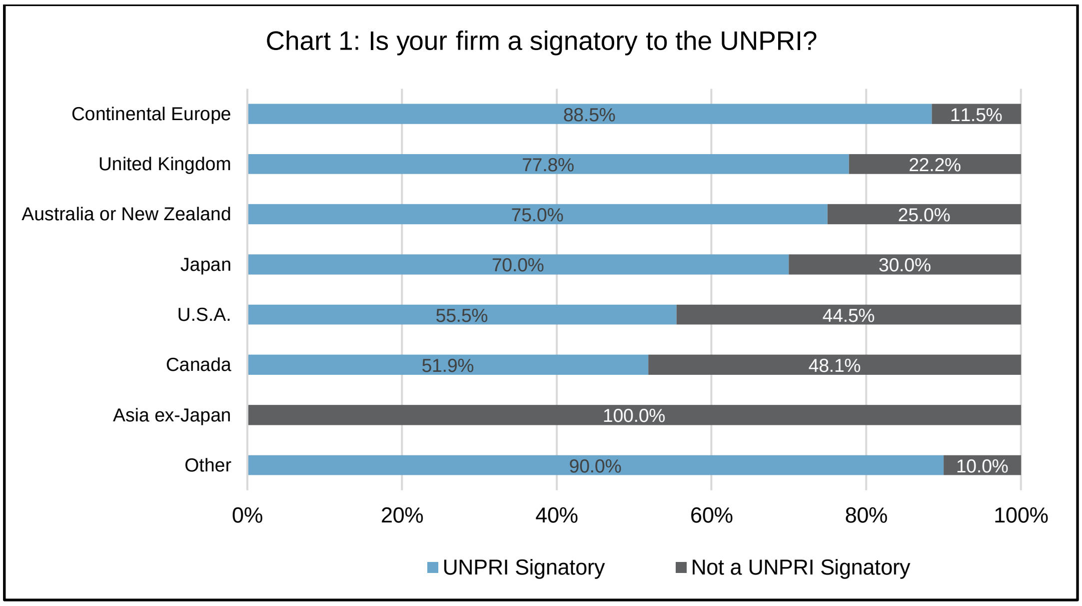
Investment process: Dedicated ESG professionals

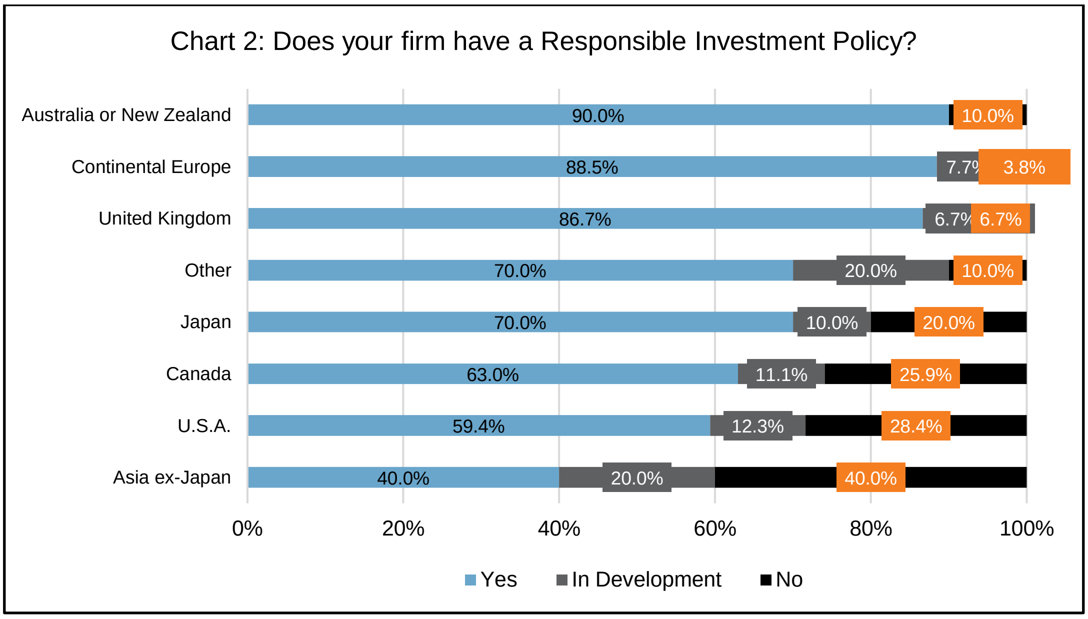
AUM is the key

According to our survey, only 36% of firms have dedicated ESG professionals who spend at least 90% of their time on ESG-specific matters. On a regional scale, firms domiciled in the U.S., Canada and Asia (ex-Japan) have the lowest percentage of firms with dedicated ESG professionals versus all surveyed regions. AUM is a very strong factor in this:

- 92% of firms with AUM greater than $500 billion have dedicated ESG professionals
- Meanwhile, 91% of firms with AUM less than $10 billion do not have dedicated ESG professionals.

This inverse relationship is unsurprising given the often-limited number of employees at small, boutique asset management firms compared to the largest asset managers.





Source for Charts 1 and 2: Russell Investments 2018 ESG survey

Investment process: The journey to integration

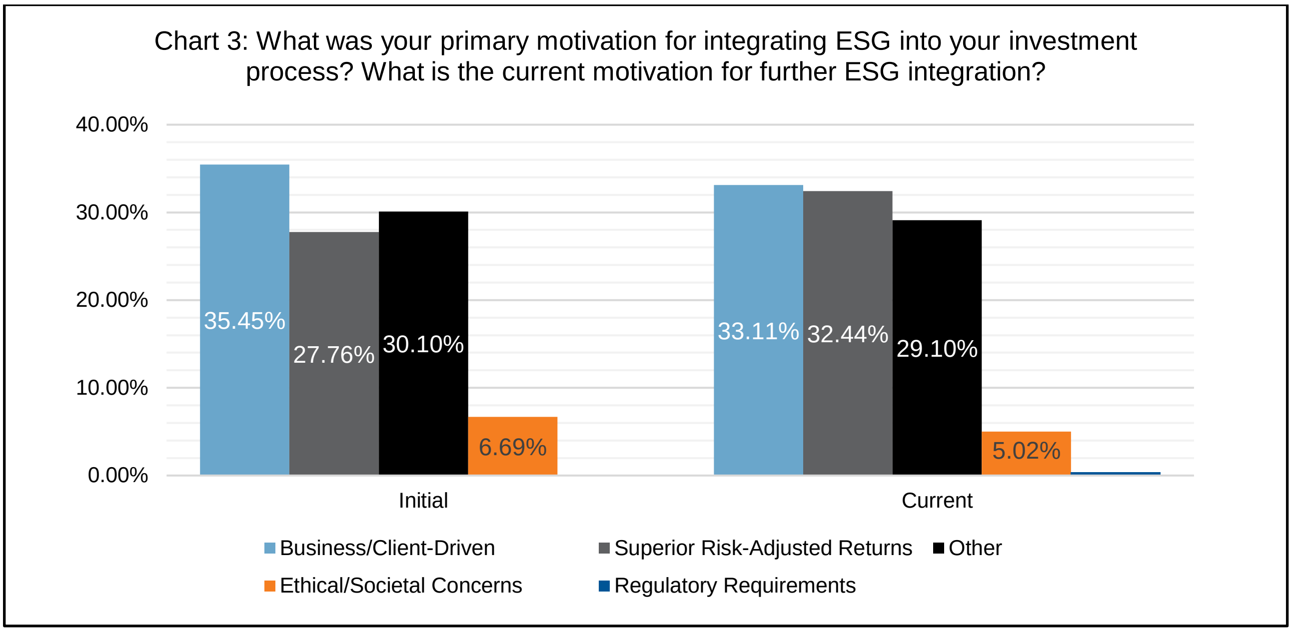
Motivation? Client demand and superior risk-adjusted returns

For 35% of firms, the primary motivation to initially integrate ESG into their investment process was business-related and in response to client demand. Meanwhile, 28% of firms were motivated by a belief in superior risk-adjusted returns.

When asked about their current primary motivation for maintaining ESG integration, the number of firms motivated by superior risk-adjusted returns increased by 4% to 32%. Business related reasons and client demand slightly decreased from 35% down to 33%. Although these shifts are small, they suggest that ESG integration is becoming slightly less business-driven and more investment-driven.

Motivation? Individual ESG factors & investment decisions – Governance trumps all

When asked which individual ESG factor has the greatest impact on investment decisions, 91% of firms cited governance. However, 35% of firms claim ESG considerations dominate investment decisions only when they increase security-specific risk. Meanwhile, only 16% claim they are dominant only when they drive positive security returns. Interestingly, 49% of firms do not allow ESG considerations to dominate investment decisions regardless of their potential to increase security-specific risk or generate positive security returns.



Source: Russell Investments 2018 ESG survey

Investment process: Data and research

Motivation? Individual ESG factors & investment decisions – Governance trumps all

Per our survey, the most common sources for ESG data and insights are ESG research vendors, direct company engagement, and company regulatory filings. The most popular ESG research vendors used by firms include, but are not limited to:

- MSCI
- Bloomberg
- ISS
- Sustainalytics.

Additional ESG research vendors cited by respondents include Trucost, Ethix, CDP, Glass Lewis, RepRisk, and Vigeo.

Use of quantitative ESG data

Progress in terms of the use of quantitative ESG data and scores in firmwide investment processes is gradual on a global scale (excluding continental Europe). In our survey, a total of 56% of firms incorporate quantitative ESG data into their investment process. Of the firms that do rely on quantitative ESG data in their investment process, 80% use a combination of both internally-produced data and externally-produced data, while 12% rely exclusively on externally-produced data.

Capital market research

When it comes to broader market insights, 31% of firms have conducted proprietary ESG capital market research to support their ESG integration efforts. Capital market research efforts decrease as firmwide levels of AUM decrease. Further to this, we found that firms domiciled in the U.S., Canada and Asia (ex-Japan) do not prioritise internal ESG capital market research (versus their more developed peers who do). These results are consistent with charts 1 and 2 above, which depict similar trends relating to geography and AUM size.

Conclusions: Geography, AUM risk management and integration effectiveness

Geography

When looking at ESG integration by region, we found that there is a clear distinction between the extent of ESG integration across multiple geographies. Continental Europe, the United Kingdom, Japan, and Australia and New Zealand consistently compare favourably to peers in the U.S., Canada and Asia (ex-Japan), across multiple ESG resourcing and integration metrics. That said, there were indications that firms based in the U.S. and Canada are progressing towards those levels of adoption and integration. It will be important to measure the year-on-year changes in ESG integration to gain better clarity into the rate of progress for the U.S., Canada and Asia ex-Japan as they catch up to regional peers.

AUM

When considering AUM levels, firms with lower levels of AUM tend to have fewer ESG resources and less ESG integration than firms with high levels of AUM do. This is intuitive, in that investment professionals at smaller firms often wear multiple hats and have fewer employees, while larger firms have centralised resource teams that can service all products more attentively.

Risk management

When one considers the situations in which ESG factors would dominate investment decisions, it appears that firms were more concerned with ESG considerations driving security-specific risk rather than positive security returns. This suggests ESG integration is broadly viewed as a risk management exercise rather than a channel through which to generate potentially higher returns.

Effectiveness of ESG integration still in flux

The integration of ESG concerns into the portfolio construction process is more transparent for ESG-labeled strategies than for non-ESG labeled product offerings. To gauge the breadth, depth and nature of ESG *integration* in a provider's investment process, we ask several questions in our manager review process to understand the ways in which ESG considerations effect portfolio construction. This includes when ESG factors should dominate one's investment decisions outside of investment guideline considerations and whether any capital market research has been conducted. Our research shows that managers are increasingly working to assess materiality of specific ESG considerations before making investment decisions. At the same time, we've observed that the increased ESG integration efforts occurring more broadly in the industry do not necessarily translate into improving ESG characteristics for non-ESG labeled strategies.

ESG integration is an important component of any evaluation

We believe that the ESG considerations made by a company or country provides a more comprehensive picture of their risks. Companies or countries who are committed to improving societal outcomes through environmental, social and governance factors will likely lead to producing positive economic value over time. Ultimately, we believe that understanding how managers integrate ESG factors into their investment decisions is an important component to evaluating their security selection and portfolio construction processes.

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