RESPONSIBLE INVESTING ROADMAP

A guide on how to implement a responsible investing framework for your organisation.

Introduction

There is increasing awareness among investors of the important role that responsible investing plays in a well-diversified portfolio. Fiduciaries today recognise that environmental, social, and governance (ESG) risk factors can materially impact portfolio performance, as well as reflect an organisation's broader values. The difficulty lies in knowing how to integrate ESG principles and where to begin. This guide will look at how you can start building a robust responsible investing framework for your organisation.

Responsible investing at Russell Investments

We're a signatory to the United Nations-supported Principles for Responsible Investment (PRI). That means Russell Investments has a firm commitment to responsible investing and we recognise its importance to our investment process. We believe ESG issues drive value and mitigate risk, and that responsible investing and performance can be complementary.

Principles of good stewardship are integrated throughout our investment process, via our research efforts, portfolio management, and implementation of proprietary investment solutions. We support our clients to integrate ESG issues into their investment process, while acknowledging that these priorities might be different for every investor.

We believe that ESG issues drive value and mitigate risk.

Responsible investing roadmap: Best practices

From our experience, we recommend five key steps on overarching best practices for establishing a responsible investing framework.

1. Educate your team

You must educate yourself and your board (or investment committee) on the meaning of responsible investing. You'll need to be aware of the latest trends and the different kinds of implementation strategies. Its critical to prepare your team members and supply them with knowledge to make informed decisions.

2. Define your beliefs

‘Responsible investing’ could be interpreted in different ways, so you must be clear on your beliefs and desired outcomes. Whether you’re aiming to align with stakeholder values, mitigate risk, or comply with regulation, you’ll need a robust framework with real integrity. It’s also important to document your responsible investing beliefs and decisions in your investment policy statement (IPS), capturing these for institutional memory.

3. Implement your beliefs

Approaches to ESG integration include (but are not limited to) exclusions or negative screening, positive selection, active ownership, and impact investing. Each approach has its own degree of effectiveness in supporting ESG principles. You may choose to utilise one or multiple approaches. Later in this series, we’ll consider each of these approaches in turn.

4. Set up a reporting framework

To have a successful responsible investing framework, you’ll need to monitor and measure how well your ESG policies are implemented within your investment portfolio.

> *We believe there are five steps of overarching best practices for establishing a responsible investing framework.*

1. Educate your team

Your responsible investment plan won't get far without engagement from your board or investment committee. Before making any decisions, you and your team need to understand what is meant by 'ESG risks', and how these risks may impact shareholder value.

Exhibit 1: Key ESG risks

Environmental

- Climate change
- Air and water pollution
- Sustainability
- Energy use

Social

- Gender and racial diversity
- Health and well-being
- Human rights
- Consumer protection

Governance

- Anti-corruption policies
- Board diversity
- Employee relations
- Executive compensation

The discussion around responsible investing is constantly evolving, so its important to get your team up to speed. Here are some more topics to consider as part of your educational process:

- The history of responsible investing
- Key terminology and investment approaches used in the industry (i.e., socially responsible investing, positive or negative/exclusionary screening, active ownership, ESG integration, impact investing, materiality, net zero investing, climate solutions, etc.)
- Fiduciary and legal implications
- Implications for investment performance and performance drivers

We recommend involving your investment provider or consultant to lead the effort to avoid introducing personal bias into the process. Ideally, this adviser should have significant responsible investing expertise.

2. Define your beliefs

Not every person or organisation will have the same values. Because 'responsible investing' can be defined in different ways, you'll need to be clear on what it means to your team. Your beliefs will be the cornerstones of your responsible investing framework.

Accommodating the diverse views of your various stakeholders can be challenging. Here are three questions you could consider starting with:

1 As an organisation, do we believe ESG risk concerns will have an impact on our portfolio?

2 Do certain ESG risk factors matter more to us than others?

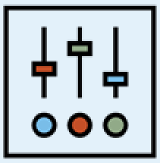
3 What changes need to be made to our investment policy statement or asset allocation strategy to reflect our beliefs captured by questions 1 & 2?

Once you and your team have decided on your responsible investing beliefs and goals, you should clearly articulate these in your investment policy statement (IPS). The IPS should include a new section incorporating the details of your new ESG beliefs as well as the governance and reporting framework that is in place. We'll look at integration and reporting in part 3 of this series.

Russell Investments' responsible investing beliefs

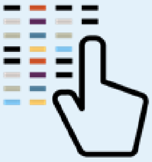
As an example of what the output of this exercise might look like, here are our responsible investing beliefs. We think ESG principles and performance can be complementary. Our solutions aim to reflect our clients' desired exposures without jeopardising returns.

Exhibit 2: Russell Investments' responsible investing beliefs



1

ESG factors impact security prices. These factors can vary by company, industry and regions, and the importance can vary through time.



2

A deep understanding of how ESG factors impact security prices is value-adding to a skilful investment process.

3

Embedding ESG considerations into a firm's culture and processes improves the likelihood of prolonged and successful investing.

4

Active ownership of securities is an effective tool for improving investment outcomes.

3. ESG implementation approaches

The PRI (Principles of Responsible Investing) defines ESG integration as 'the explicit and systematic inclusion of ESG issues in investment analysis and investment decisions.[1] To put it another way, it means proactively considering sustainability or other social factors during your investment process.

Should I use an active or passive approach when investing responsibly?

Companies with robust ESG practices are more likely to have enduring business models. Investing in these companies can help deliver portfolio performance over the long term and reduce volatility in the interim. While passive strategies like ESG index tracker funds can offer access, an active approach is better suited towards recognising these opportunities. Active management is particularly useful for ESG fixed income investing given some of the unique technical characteristics of the asset class.

Why active management and ESG integration are a good fit:

- ESG risks are often not adequately priced into the market. For example, we believe global equities is an asset class where active management generates alpha. With ESG risks priced inadequately, there are good opportunities for active managers to generate alpha in ESG equity strategies.
- More broadly speaking, robust ESG management by companies gives a good indication of overall quality and helps identify the companies most likely to have successful long-term business models.
- Active management also makes better use of the power of engagement and stewardship and holds greater weight when voting. On the other hand, passive investing replaces this human element with a benchmark-driven approach, which cannot be matched entirely to a client's responsible investing beliefs.

> *…Companies with robust ESG practices are more likely to have enduring business models.*

Incorporating negative ESG exclusions or positive ESG screens

An 'exclusion' is when an entire sector, country, or company are excluded from a portfolio. It's the simplest way to implement ESG considerations. The screening process uses transparent metrics like activities (e.g., animal testing), practices (e.g., corruption levels), personal values (e.g., gambling) and risk considerations (e.g., nuclear power). Political issues could also be a consideration.

What is positive selection?

Positive screens – factors that you want more exposure to – could be stocks in companies that use renewable energy or that score highly in employee satisfaction.

[1] UNPRI. (2018, April 25). "The term "ESG integration" is often used when talking about ESG investing." Available at: https://www.unpri.org/fixed-income/what-is-esg-integration/3052.article

How to incorporate negative or positive ESG screens?

There are a few ways of incorporating these negative or positive ESG screens, depending on your provider.

For commingled fund managers, choose managers that incorporate your desired exclusions or positive ESG screens. However, ensuring uniform exclusions or screens across all managers may be difficult. Even ESG-conscious managers are likely to have small differences in which stocks they include or which screens to utilise.

For separate account mandates, you can often work with a manager to incorporate negative exclusions or positive ESG screens. If a manager doesn't have the capabilitity to do so, another option may be to use a different implementation manager to handle these exclusions or screens.

Make sure your manager or implementation partner understands and can implement the ESG exclusions you desire. For example, any exclusions by carbon footprint could result in unintended consequences like underweighting companies that are making significant strides in energy transition. This would compromise the benefit of ESG incorporation in the first place.

ESG Manager Survey

Our annual ESG survey of active managers assesses the integration of ESG considerations in investment processes among equity, fixed income and private markets managers.

Read the survey results at:
russellinvestments.com/uk/blog/2021-annual-esg-manager-survey

Active ownership

Active ownership is the use of the rights to influence the activities of investee companies. Active ownership, whether through proxy voting or shareholder engagement, is generally regarded as an effective mechanism to reduce ESG-related risks, maximise returns, and have a positive impact on society and the environment.

Proxy voting

Proxy voting is the exercise of voting rights on management and/or shareholder resolutions to formally express approval (or disapproval) on something. Voting can be done in person, during an Assembly General Meeting (AGM), or by proxy (i.e., proxy voting).

Shareholder engagement

Shareholder engagement is any interaction between the investor and investee companies in relation to ESG practices or disclosure. It helps enhance shareholder value and rights. Engagement can happen at multiple levels, whether via sub-advisers, market participants, or direct corporate engagements.

Bondholder engagement

Engagement is more common among equity investors. But our annual ESG Manager Survey showed that fixed income managers are beginning to leverage the unique features of fixed income investing in a more implicit manner. While bondholders do not have voting rights per se, as capital providers to corporations, they do have a direct line of communication to management.

That said, the explicit limitation exists for bondholders who cannot engage in proxy voting. We have observed that fixed income market practitioners with equity offerings leverage their equity counterparts to increase influence. Some bond managers who have limited or no equity offering look to partner with other bond managers to similarly have their voices heard. Russell Investments is a member of Climate Action 100+, an investor-led climate engagement coalition that launched in 2017 to help such bond managers coordinate their engagement activities with other investors.

4. Establish a reporting framework

Now it's time to ask: how will you measure how well your ESG policies are being implemented? A robust reporting framework helps communicate your efforts to your stakeholders and community, demonstrating the positive work your organisation is accomplishing.

Your investment manager or investment consultant should have the capacity to report your investments' impact. However, you'll still need to create a process to evaluate your portfolio's ESG performance, whether it be through climate disclosures or metrics-driven reporting.

Task Force on Climate-related Financial Disclosures (TCFD)

Investors are demanding more disclosure on portfolio positioning and regulators around the world are expanding their requirements. Your provider should have a thorough understanding of the implications of climate change for investing and provide you with the information you need.

We recommend that you and your provider review the TCFD initiative, which was established by the Financial Stability Board (FSB) in December 2015. The initiative created a set of voluntary, consistent disclosure recommendations for use by companies providing information to investors about their climate-related financial risks. The TCFD has an established framework for reporting on climate-related topics, as illustrated in Exhibit 5.

Exhibit 5: Core elements of recommended climate-related financial disclosures

Governance

The organisation's governance around climate-related risks and opportunities

Strategy

The actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy, and financial planning

Risk management

The processes used by the organisation to identify, assess, and manage climate-related risks

Metrics and targets

The metrics and targets used to assess and manage relevant climate-related risks and opportunities

Source: TCFD.

Metrics-driven reporting

Demand for metrics-driven reporting is generally twofold: one for ESG criteria broadly, and one for metrics related to climate change, such as carbon footprint.

You should make sure your provider can put together detailed ESG reports both at the individual fund and total portfolio level. These reports include key statistics on ESG factors such as ESG risk scores, carbon footprint indicators, and exposures to certain sectors (i.e., tobacco). They also include proprietary information for portfolio managers on the vast array of details related to responsible investing ranks, metrics, and engagements.

The images in Exhibit 6 are examples of total portfolio-level ESG reporting. Reporting should be tailored to meet the specific needs of your organisation.

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Communicate and collaborate

Finally, now that your framework is in place, its time to let people know about it! Effective communication of your efforts to your stakeholders will help to maintain confidence in the framework. You may also want to seek out and collaborate with organisations that share your values. At Russell Investments, we partner with organisations to promote the inclusion of sustainability in investment processes, such as the PRI, Climate Action100, Investors Group on Climate Change (IIGCC), Carbon Disclosure Project (CDP) and the Task Force on Climate-related Financial Disclosure (TCFD).

The bottom line

We believe that responsible investing is intelligent investing. ESG values are a sign of well-run teams and future-proofed business models.

Integrating these principles isn't easy, but it's worth it. Start by engaging your wider team and agree on what values are important to your organisation. Then you can consider integration methods, like screening and different ownership styles. Once you have decided on the method that works for you, establish a reporting framework to ensure your goals are being met.

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