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Implementation Insight

ESG sous examen:
Leçons de sélections de gestionnaires

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Pourquoi Lire la Suite?

Les considérations environnementales, sociales et de gouvernance continuent à prendre de l'importance dans le milieu de l'investissement, et ce dans toutes les classes d'actifs.

Toutefois, les priorités et principes liés aux critères ESG variant très fortement d'un investisseur à l'autre, l'alignement entre gestionnaire de fonds et allocataire d'actifs n'est pas évident.

Aux fins de cet article, nous avons examiné cinq recherches de gestionnaire très récentes et personnalisées sur des marchés cotés et privés où les critères ESG jouaient un rôle significatif. Deux de ces engagements - un exercice de sélection de **dette privée** pour l'Environment Agency Pension Fund britannique et une recherche en **actions cotées** d'un family office européen - sont présentés en détail (pp. 6 - 12).

Nous espérons que des informations spécifiques tirées d'exemples pratiques, à l'inverse de simples généralités, s'avéreront utiles autant pour les investisseurs que pour les gestionnaires impliqués dans ce secteur. Bon nombre de ces leçons ont trait à l'analyse des gestionnaires, ou l'art de défaire un habillage toujours plus sophistiqué pour évaluer les véritables pratiques. Tandis que le nombre d'offres estampillées ESG ne cesse de croître à travers les classes d'actifs, il devient de plus en plus difficile de séparer le bon grain de l'ivraie entre un marketing qui tente de cocher toutes les cases et la véritable substance.

Dans l'ensemble, l'univers des produits et des stratégies continue de s'écarter des exclusions et sélections, pour se rapprocher d'une intégration bottom-up des facteurs et d'un engagement actif. En effet, des publications récentes telles que celle de CalPERS sur les sous-performances provoquées par l'approche par exclusion risquent de renforcer la tendance actuelle. Néanmoins, chacune de ces approches, en particulier l'intégration, peut prendre de nombreuses formes.

La principale chose à retenir des opérations de sélection de gestionnaires ESG en 2016 est sans doute la grande diversité de la demande. Certains investisseurs abordent les critères ESG sous un angle foncièrement éthique, d'autres considèrent plutôt la gestion des risques; une dichotomie qui perdure. **L'expérience nous apprend qu'une même stratégie et une même équipe peuvent souvent satisfaire aux exigences d'un investisseur sans y parvenir pour un autre**, ce qui souligne l'importance d'une approche sur mesure.

Cette dichotomie permet également d'expliquer pourquoi - comme le démontrent nos recherches internes - les progrès en termes de normalisation se sont avérés laborieux, même pour les actions cotées. Les mandats dédiés sur mesure demeurent la «norme». Cela devrait continuer: les investisseurs institutionnels ont chacun d'entre eux une vision profondément personnelle de l'investissement responsable. Mais dans le même temps, nous pensons sincèrement qu'il existe parmi les investisseurs et les gestionnaires d'actifs des acteurs qui apprécieraient un changement vers davantage d'uniformité des politiques en la matière, peut-être initié par une entité telle que la PRI.

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Latest News

Donald Trump's victory has had a negative short-term performance impact on portfolios with a sustainable angle, particularly on the environmental side and most notably where the companies are early-stage and developing innovative technology. Yet the longer-term picture is unclear: Trump has not clearly indicated that U.S. government-backed ESG-related projects or bodies will be in the firing line.

More than 125 active global equity managers now offer an ESG-oriented product. Of these, nearly a quarter (23%) have a track record shorter than three years and 70% under 10 years after a decade of remarkable proliferation. In comparison, nearly two thirds of traditional active equity offerings present track records of more than 10 years.

The number of PRI (Principles for Responsible Investment) signatories has exceeded 1600 for the first time, with 223 joining in the year to April 2016. According to PRI, the AuM of investment manager signatories represents three quarters of total investment manager AuM worldwide; the proportion on the asset owner side is much lower.

Diversity of Demand

To describe ESG as a "broad church" would be something of an understatement.

Some investors approach this subject from a definitively ethical perspective; others view it from a pure risk management standpoint. One investor may desire a high degree of activism, wanting to see prospective managers driving change at portfolio companies; another may not have strong expectations on this point. Commentators frequently refer to the emergence of new stakeholders with a stronger appetite for value-driven investments, particularly so-called millennials.

A significant portion of ESG-oriented investors are open to working with managers that have not yet moved far in the direction of responsible investment but are willing to change. Indeed, they present their influence on the asset management industry as a form of impact. Others, by way of contrast, require strongly institutionalised existing processes.

The variations continue. Certain institutions place far more emphasis on specific sub-themes within the ESG spectrum, most notably climate change, than other peers. "De-carbonisation of equity portfolios" has become increasingly popular in Europe, with major investors such as FRR taking the lead, but has scarcely broken ground in the USA, where governance is still the predominant angle. We expect that the majority of environmentally-oriented institutions will continue to emphasise this theme going forwards, regardless of whatever effect the policies of President-elect Trump may have on pricing; others may re-evaluate the investment rationale as the regulatory and legislative picture evolves.

Several European pension funds will only accept managers that are signatories to the Principles for Responsible Investment (PRI), even in asset classes where this severely restricts the available pool of providers. For instance, in one manager selection process for U.S. small-cap equity, the European pension fund client saw their shortlist shrink from 20 to just two, simply based on the fact that PRI affiliation was a board-mandated requirement. Meanwhile, there are many investors who take ESG very seriously indeed but do not see PRI affiliation as being highly significant. Indeed, PRI itself has publicly stated its intention to address "signatories without substance" and we warmly await the review of this body's priorities for the next decade, due in early 2017.

Even straightforward exclusion criteria vary dramatically, as do interpretations of how those exclusions should be applied. What proportion of company revenues must derive from a disqualified area in order for the stock to be filtered out? Should a tobacco screen apply only to tobacco companies or to other firms such as marketing companies, consultants or packaging producers that derive money from the sector? Investors bring different answers to these questions.

Multiple asset owners - and indeed asset managers - have sought to copy a version of "best practice" rather than invent their own policies. The most common exemplar, based on our research, is the Norwegian Government Pension Fund Global: multiple pooled funds, and indeed many pension funds ranging from the Nordics to as far afield as Australia, have replicated part or all of this SWF's ESG policy. Such replication does come with a health warning: one client discovered through experience that this template did not translate well into infrastructure investments, causing problems which later necessitated a change in approach. Yet such activities do suggest that one branch of the ESG family would welcome greater leadership on standardisation, as discussed later in this paper.

Given these variations, generic ratings on the quality of a manager's ESG practices do not map easily onto a highly diverse reality and should be taken with more than a pinch of salt. At worst, non-bespoke scoring can unduly limit the available pool of providers from which an investor can choose.

Asset Managers and ESG: A Basic Framework

It would be difficult to present a common framework across all asset classes for analysing managers' approaches to ESG.

Yet we do believe that it can be helpful to look at strategies through two basic lenses: what stage of the process ESG considerations inhabit and whether the methods used are "top-down" or "bottom-up".

We would generally view it as a positive sign for a manager to exhibit behaviours across a wide range of the fields, although that would not in itself connote a strong process. Bottom-up approaches, for instance, can often be the most thoughtful but top-down structure can provide muscle. In addition, the investor's own preferences and requirements will influence whether top-down or bottom-up strategies may be appropriate.

Indeed, asset allocators can think about the same two lenses when considering their own process. Is ESG driven from on-high by the board and stakeholders and/or embedded into the DNA of the team's analytical process? Does it sit primarily in one part of the decision-making chain or feature at multiple stages?

Asset managers and ESG integration: a universal framework

	ESG Philosophy and Policy	ESG in the Investment Process	ESG Monitoring and Review
"Top-Down"	Big picture/thematic way of thinking May be more ethical/values-based ESG risks and/or opportunities viewed through a lens of regional/sector "building blocks" Seek to target/avoid broader cohorts of assets/securities based on high level ESG dynamics	Exclusionary screen at regional/sector level or commercial ESG benchmark constrains the investible ESG universe Reliance on major external ESG rating providers Standardised ESG due diligence "checklist" for each investment Decision-making considers ESG "red flags" in isolation from financial factors	Regular refresh of standardised ESG checklist Alert of ESG rating downgrade prompts partial or full divestment Reliance on major proxy voting advisory services Standardised client ESG reporting based on external research
"Bottom-Up"	Focus is on ESG risks and/or opportunities at asset/security level Comfortable to distinguish between assets/securities in same region/sector on ESG factors Specialist ESG resourcing fully integrated at all levels of the manager's organisational structure Use of external ESG resources is supplementary to internal effort	ESG scoring by asset/security Granular and flexible approach to ESG scoring for each investment Focus on internally-generated ESG research and scoring Decision-making has fully integrated consideration of ESG and financial factors	Continual review of asset/security-level ESG scoring Internally-driven management/co-investor engagement process Hands-on, ESG-consistent and collaborative approach to default/work-outs Proprietary and active proxy voting process Tailored ESG client reporting and dialogue

DNA of a Manager Search: Private Debt

In September 2016, bfinance conducted a search for a private debt manager on behalf of the UK Environment Agency Pension Fund (EAPF), seeking to allocate £50 million in one or two mandates.

Sustainability is fundamentally important to the Environment Agency Pension Fund, which is widely recognised as a leader on ESG investment. Yet the EAPF's senior staff fully recognised the potential challenge of applying responsible investment criteria in this particular asset class.

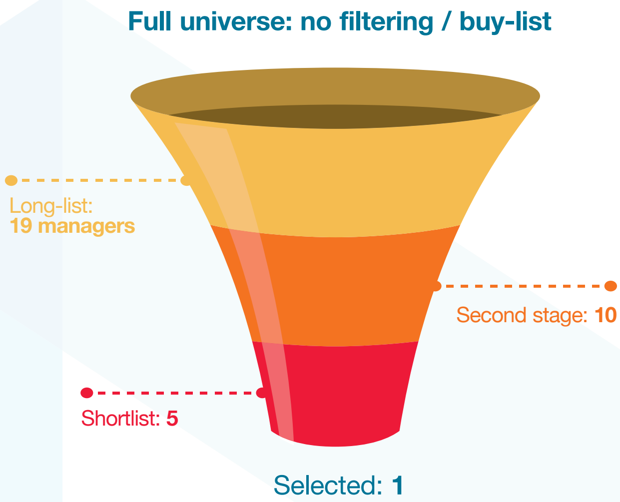
"We very realistic in our expectations here," CIO Mark Mansley told one shortlisted manager, "recognising that the typical sector mix in private debt limits how material ESG issues are in many cases (except for governance) and that the industry is generally at a fairly early stage on ESG integration. Our approach here is best expressed as responsible."

With this in view, basic ESG indicators were allocated a relatively low weighting (5%) during the initial suitability analysis, which was used to whittle down a long-list of 19 to a more refined group of 10. That assessment did take account of which managers were signatories to PRI (8 of 19), which had dedicated ESG staff, which adapted screenings for clients, which used external ratings providers such as Sustainalytics and so forth, but with a scoring system that would not preclude managers without these blunt indicators from progressing further.

It is appropriate that these indicators are not given excessive weight. The presence of a dedicated ESG head or team but doesn't necessarily translate into real influence, such as an independent voice on the credit committee with potential veto power, or true participation in the investment process. Membership of relevant organisations does not require a high degree of integration or commitment.

Yet from that point onwards, during the more qualitative stages, sustainability considerations came to the fore. In-depth assessment of the team's practices relative to this investor's requirements proved to be critically relevant. For instance, one shortlisted manager - one of the larger private debt managers in Europe, which held a good ESG rating from EAPF's main consultant despite their below-average ESG score in our initial quantitative analysis - proved to be somewhat weak on this aspect during meetings with the bfinance team and the client. The firm had one of the three strongest offerings from a non-ESG standpoint, so this point proved to be critical.

Mandate at a glance
Net IRR target of 6-8%+, regular income distributions of 6%.
Strategy focus: corporate debt, buy-and-hold. Open to most corporate debt types across senior, unitranche, with limited exposure to subordinated and mezzanine investments.
Predominantly focused on Western Europe including UK but could consider Global.
Duration target of 8 - 10 years.
Investor wishes to represent no more than 25% of Fund commitments.
The strategy should consider ESG sustainability.



The winning debt manager, it's worth noting, was not rated by any of the largest investment consultants in Europe. They are also not a PRI signatory, although they indicated their intention to become one and EAPF intends to encourage them in this direction. Aside from strong fundamental processes, the investor felt that their strategy itself - which is very much focused on growth capital - can also be considered societally beneficial.

"Before ESG came into play within private debt, there has long been a focus on EHS - Environment, Health and Safety," notes Niels Bodenheim, Director of Private Markets. "When we look at ESG in this asset class, the E therefore tends to be the easier part. The S and G are less well advanced. That being said, one could argue that ESG is naturally stronger here than it would be in listed markets, as part of process, because of the more thorough review conducted on each deal.

"There are hundreds or even thousands of pages of due diligence. ... Every European private debt manager will only do perhaps 20 or 30 deals per year, out of the 2-300 they would look at."

It would be possible to categorise ESG integration approaches among the 19 long-listed private debt managers into two broad camps, which are not mutually exclusive.

> Early incorporation. In some cases, ESG factors were considered during the first phase of screening for deals.

> Late-stage assessment. In other examples, ESG was dealt with during the final approval process.

With the latter, the manager does run the risk of becoming wedded to the opportunity before considering the ESG aspect. Having put a great deal of work into a deal, it is natural to develop a vested interest in its completion. Yet the truth is that one approach isn't necessarily superior to the other. "There's always a flip-side," says Bodenheim. "When a firm does ratings - rating the level of ESG risk from low to moderate to high - what's actually done with that information? We have done due diligence on managers who will still do deals that have been rated high-risk from an ESG standpoint by their own process."

Negative exclusion was also practiced by several private debt managers that participated in this search but, as our research demonstrated, these exclusions are not always rigorously adhered to if they're not formalised as part of fund policy. We have seen examples of managers that refer to or imply certain restrictions but then turn out - for instance - to have a gaming business in the portfolio. If certain exclusions are part of an investor's policy, this is an important aspect of due diligence.

Qualitative analysis and engagement is crucial to understanding how managers really handle ESG issues. “One manager in the final ten in this search claimed to be very focused on ESG,” says Bodenheim. “They are members of many relevant organisations including PRI, they have a dedicated impact team and so on. But when you dig into the role that the team plays in the process you get a different picture.

“You also need to hear from a range of people: if the ESG person comes and presents then of course you will hear that ESG is fundamental. You need to question the people that are doing the transactions day to day. You also need to hear from the people who do the monitoring. The approach to work-out - how the manager treats distressed situations - is very important with private debt and very much has an ESG dimension: is it consistent with ESG principles, i.e. not fee-generative but really involving working with the companies to make sure sustainability and governance aspects are high priority?”

Fees

Below are the fees initially quoted by managers responding to this RFP. It should be noted that these figures precede several stages of negotiation on price and the winning manager did offer a meaningful reduction versus their initial quote. The range of fees below is certainly competitive relative to other private debt searches at this stage and illustrates that incorporating ESG considerations should not involve higher fees.

It’s worth noting that the managers with higher base fees also tended to have higher performance fees: the only manager with the 2% base fee quoted 20% carried interest. In addition, the majority of managers at long-list stage (14/19) proposed charging management fees only on net invested capital, with a minority charging on committed capital. The former was strongly preferred.

Quoted fees for this mandate

	Base management fee	Carried interest	Hurdle rate
Median	0.85%	10%	5.50%
Best quartile	0.79%	10%	6.00%
Worst quartile	1.00%	14%	5.00%
Range	0.3 - 2.0%	0 - 20%	4 - 9.5%

DNA of a Manager Search: Public Equity

In August 2016, bfinance conducted a search for a global ESG equity manager on behalf of a family office seeking to allocate $75-85 million in a single mandate.

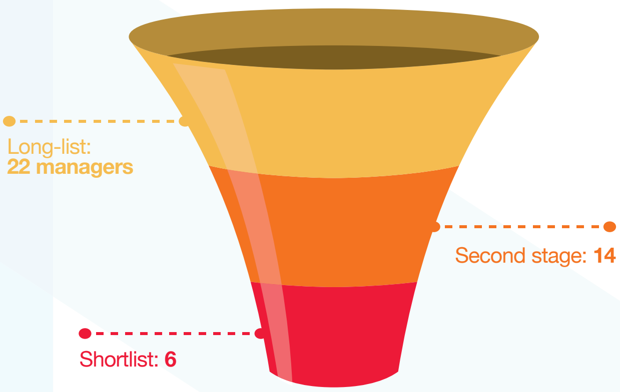
"There are, speaking generically, three approaches currently adopted by fund managers when constructing ESG equity portfolios," says Joey Alcock, Senior Associate in bfinance's Public Markets Advisory team.

"In **holistic / bottom up** methodologies, the fund manager typically incorporates a range of ESG criteria into the investment process and against which all potential investee stocks are scored. Typically, stocks which score poorly on ESG have a lower probability of being purchased for the portfolio. Conversely, **screening/top-down** approaches see the fund manager systematically removing particular cohorts of stocks based on certain characteristics, often screening certain sectors from the investible universe completely and often on a customised basis. Many managers do use a **blend of both.**"

In this case, the investor was happy to consider either a dedicated ESG strategy or a traditional strategy with an exclusion list to be applied. Of the 55 offers received for this search, 31 managers proposed strategies that included formal integration of ESG considerations into the investment process, with the remaining offering to customise existing non-ESG strategies. Eighteen of those 31 offered pooled vehicles.

Mandate at a glance
Investor prefers pooled vehicle (above $300m size) over segregated account.
Active, long-only, global; no preference on investment style.
Small-cap exposure capped at 15%; emerging markets capped at 10%.
Preference for a three-year minimum track record and $1 billion current AuM in the proposed strategy
ESG-related policies and ESG-influenced investment beliefs.
Ability for client to monitor that manager is operating consistently with ESG-related policies and practice, including disclosure of ESG-related incidents and the manager's response.
ESG to be addressed in a structured process, including reporting to client.
Stock exclusion list including tobacco, armaments and adult entertainment (revenues >5%).

Full universe: no filtering / buy-list



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In the first instance, this particular search involved some key exclusionary requirements. The investor - a large family office - had strong reasons for an ethical approach stemming from the family's historic business activities. Indeed, strict negative screens are often the result of value-driven considerations rather than investment-driven ones. Adult entertainment, for example, is an intuitively stable industry, not negatively impacted by regulation or structurally shrinking markets.

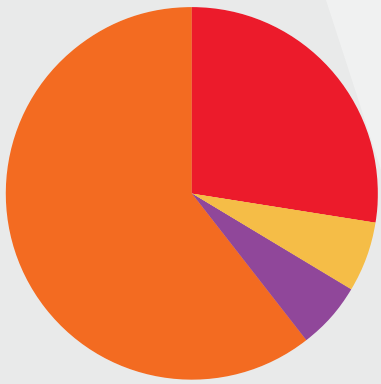
Because such requirements are often purely ethical in nature, they also are far less likely to be flexible. This does pose a challenge for accessing pooled funds. Investors find that even a seemingly minor variation between their criteria and the manager's can rule out that fund from being investible. For this reason, we observe that many asset owners (though not in this case) are prepared to omit their pooled fund investments from their own exclusion rules.

In the case of this search, the client had initially expressed a **preference for a pooled vehicle,** deemed more convenient from an administrative perspective. Yet, of the 18 pooled funds proposed by managers during this search process, 11 do not incorporate any systematic exclusions and only five met the necessary criteria. Fast forwarding to the end of the process, the client ultimately undertook in-depth due diligence on four fund managers, of which only one offered a pooled fund. A segregated mandate was finally chosen.

The chart below may prove particularly helpful in illustrating the nature of the pooled fund universe in terms of exclusion. It groups the offerings based on whether they excluded Tobacco (T), Weapons (W) and Adult Entertainment (A). Other screens were observed including alcohol, gambling, nuclear power, carbon-intensive industries, animal testing and intensive farming, but these are not shown.

The majority (61%) of pooled funds in this sample do not employ any exclusion and the second largest group (28%) exclude all three, with only two managers not falling into these brackets. In other words, the pooled fund universe tends to bifurcate into "don't exclude" or "exclude all/most." The latter camp intends to capture the broadest possible group of investors that require any type of screening; the former seeks to appeal to the rest.

Exclusion of Tobacco, Weapons and Adult Entertainment: 18 Global ESG Equity Pooled Funds



28%	Exclude Tobacco, Weapons and Adult Entertainment
6%	Exclude Tobacco and Weapons
6%	Exclude only Weapons
61%	No exclusions

Of course, “not excluded” does not necessarily indicate that the portfolio has exposure to the relevant sectors, whether in a pooled or segregated context. Where a fund manager is instead employing bottom-up ESG scoring as part of stock research, the likelihood of such companies making it into the portfolio may still be negligible. Overall, the industry continues to migrate in the direction of bottom-up analysis at the expense of straightforward screens, although there will continue to be many clients who do require firm guarantees.

Going beyond exclusion and basic categorisations, deeper quantitative and qualitative analysis reveals multiple dimensions of ESG integration. As with the Private Debt search presented previously, meetings with managers proved critical in digging down into these differences, unpicking the difference between pro forma answers and real practices.

Whilst this subject can be quite nuanced, it is possible to categorise these different approaches - roughly - into a set of seven “aspects,” as shown in the figure below.

“Managers deemed to have more sophisticated approaches to ESG typically tend to occupy more of the pink fields and, often, a combination of both sides,” explains Alcock, referring to the table shown below. “For example using external ratings from the likes of Sustainalytics as a way to test or challenge internal ratings tends to be a highly positive indicator. Similarly, the presence of specialist ESG personnel is clearly no guarantor of sophistication, particularly if they and their work are not fully integrated into the process.”

In the case of this mandate, managers across different parts of the spectrum made it through to the investor’s shortlist. Indeed, one of the final four occupied exclusively blue territory. Yet other investors can take a more demanding approach to particular aspects of the integration picture, particularly the issue of company engagement. This underscores the importance of a client-specific approach. Over time, the equity management industry as a whole does appear to be migrating gradually from left to right in terms of its approach, as discussed in the later Trends and Themes.

One challenge that investors do face in this sector, particularly when assessing ESG-integrated products, is the significantly shorter average track record than they would find for traditional equity. Only 32% of ESG-integrated offerings in this search had a track record of more than 10 years, versus nearly two thirds of the traditional offerings. The industry-wide proportion is even lower, with a raft of new products emerging each year, but the investor in this case had expressed a specific preference for a three-year minimum. Even where track records are significant, they may not precisely match the nature of that client’s customisation requirements, meaning that the retrospective impact of additional sector exclusions should be taken into consideration.

The ESG integration spectrum

ESG aspect	Simple	Complex
Staffing	Generalists with ESG skills	Specialist ESG personnel
Research and inputs	External (Sustainalytics, MSCI etc)	Internally-generated proprietary
Decision-making (A)	Overlay screen	Embedded in multiple dimensions
Decision-making (B)	ESG as Risk	ESG as Opportunity
Company engagement	Divestment of holdings	Ongoing dialogue
Proxy voting	Outsourced to proxy advisors	Proprietary internal determination
Collective activities	Passive participation	Active collaboration

Low prices were not a high priority for this investor, which had also expressed a strong preference for a flat fee rather than a base+performance structure.

Fee data for this mandate is shown below, although it should be noted that these were fees quoted at an initial stage, before any rounds of elimination or negotiation. The winning manager did agree on a lower fee than was initially quoted.

Quoted fees for this mandate

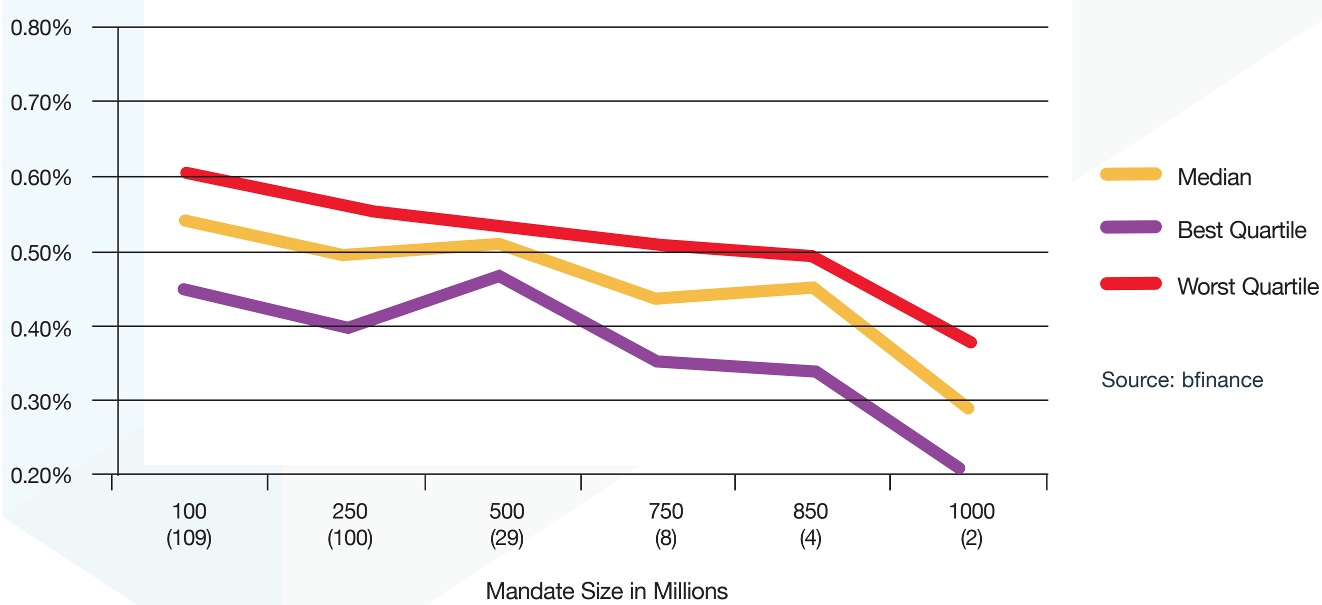
Median	0.57%
Best quartile	0.49%
Worst quartile	0.66%
Range	0.43 - 0.75%

Looking more deeply into the figures, there appears to be no difference in the median fee for "ESG-integrated" approaches and those offering screens for a traditional strategy. Furthermore, quoted fees for other global equity searches in 2016 (as presented below) illustrates that the figures for this mandate are broadly in line with non-ESG averages. Again, it should be noted that these are opening offers only.

One final conclusion is worth mentioning. Going forwards, based on findings from this and other global ESG equity searches, we have been actively encouraging asset managers to consider membership of ESG-related organisations such as PRI in order to avoid being excluded at an early stage from future searches by investors who prioritise that particular issue. Yet, at the same time, we advise clients to be cautious about placing excessive weight on such memberships. Whilst the mission of the PRI is clearly laudable, as is its desire to build a broad base encompassing a large proportion of global AuM, the fact is that we do see firms with a solid approach to responsible investment that choose not to affiliate themselves.

One non-signatory told us that, as a smaller manager, the PRI fees had proven prohibitive. "We are very confident that we would meet all of the PRI requirements, so this is not a decision based in complication to our firm or investment process," a representative explained. Yet things have changed. "It seems they have lowered their costs dramatically. The data requirement seems much less as well ... so we will proceed with the registration in Q1 2017."

Quoted fees for Global Equities Mandate (non-ESG)



Source: bfinance

Trends and Themes

The "evolution" of sustainable investing is a popular subject in today's investment marketplace.

Multiple asset manager white papers and presentations offer charts similar to the one below. The proposed evolution, in this case, is a movement from top to bottom over time. This is a reasonable analysis. There certainly has been a trend from screening towards integration, although the former remains highly important. The rise of thematic investing during the past decade has also been notable. It is worth considering this table alongside the table on page 11, which illustrates more granular shifts towards a less simplistic approach.

In practice, the "evolution" is more multi-dimensional, moving outwards along many vectors from the historical roots in ethics, reflecting the theme of diversity of demand. The distinctions between "integration" and "impact" - aside from the packaging and message - are sometimes unclear. "Impact" (the younger, more fashionable sibling of Engagement or Activist Investing) has become the buzz-word du jour, whereas ESG has started to sound somewhat generic from a marketing standpoint.

Evolution of sustainable investing

Category	Definition	Objective
Socially Responsible Investment (SRI)/ Values alignment	Screen out irresponsible "sin stock" companies, such as tobacco, alcohol, and gambling: and/or only invest in leaders in sustainability	Social mission
Environmental, Social and Governance (ESG) Integration	Integrates ESG risks and opportunities into investment analysis and dialogues with portfolio companies	Seeks better risk-adjusted, long-term performance
Thematic Investing	ESG themes such as climate change, water scarcity, or women's empowerment	Investment opportunity
Impact Investing	Invests in companies with the intention to generate a measurable and beneficial social or enviornmental impact alongside a financial return.	Measurable societal or environmental impact and financial return

Source: Wellington

It is particularly worth noting the "objectives" above. "SRI" is assigned to a values-driven approach, "Integration" and "Thematic" are categorised as financially-driven and "Impact" reverts somewhat to values. The truth is that, whilst repeated studies have demonstrated that ESG funds do not underperform, the jury is still out on whether ESG integration is strongly associated with excess long-term performance. As such, the "Impact" story - providing investors with proof of measurable societal or environmental effects - becomes even more relevant.

Screening and negative exclusion, despite the above shift, are certainly not going away any time soon. In the case of Global equity strategies, this persistence is perfectly reasonable: both bfinance and relevant fund managers do not view exclusion lists as being necessarily detrimental to effective portfolio construction relative to a standard global equity benchmark, given the breadth and depth of the market. Yet this may not be the case in other geographies, or indeed other asset classes. For example, a Canadian equity mandate which excluded oil-related stocks on ESG grounds would not have access to around a quarter of the market, producing significant benchmark-relative risk. Similarly, in fixed income we have worked with a client whose ethical considerations precluded investment in U.S. sovereign bonds due to that country's use of the death penalty.

Indeed, one particular area of growth within the screening/exclusionary category is the rise of **Sharia-compliant strategies** for listed equity. A recent bfinance white paper entitled *DNA of a Manager Search: Global Sharia Equities* provides further insight on this niche within the market.

Increasingly, ESG-focused investors are making it a priority to move beyond equity and integrate relevant factors into their fixed income and alternative investments.

As was the case for the Environment Agency Pension Fund in their private debt search, investors in private markets are prepared to take a very sanguine approach. There is a strong willingness to be flexible and adapt to existing realities. For instance, a **Private Equity** Fund-of-Funds search recently conducted for a Nordic pension fund did not significantly weight ESG factors in the first-stage assessment, although this investor is deeply committed to sustainability.

“The underlying private equity funds, with a small-to-mid-market focus, will naturally not prioritise ESG issues,” says Anne Feuillen, Senior Director - Private Markets. “These managers tend to be small, without many resources. The portfolio companies themselves may be family businesses where this has just not been thought about before. There are usually far bigger problems to deal with at these firms, such as the absence of key staff or key functions, and that is what the manager will focus on.”

That being said, there is a widespread conviction among asset owners that ESG aspects are often inherently more advanced in many **private market** investments than in public markets, regardless of how they’re labelled. Investors in unlisted real estate and infrastructure, who will hold assets for many years in relatively concentrated portfolios, will naturally be more likely to focus on sustainability, reputation, environmental risks, strong governance and social factors as part of their long-horizon risk management.

In addition, many of the strongest individual examples of “thematic” investing, and indeed “impact,” lie in the unlisted sphere: renewable energy, green property and the like are increasingly popular. One of the most interesting, unusual engagements that bfinance performed during the past three months was a search for a renewable infrastructure manager. The pension fund’s existing consultant didn’t provide sufficient optionality in terms of the number and types of provider - a frequent challenge in the more niche parts of the sustainable investment spectrum - making a bespoke, full-universe search preferable. In that example, 18 RFP responses were obtained, representing a 200% increase on the longlist that would have been available to the client otherwise. One of the two managers selected had never engaged with any consultant or indeed answered any RFP before this search.

Among **public bond managers,** there is a nascent universe of ESG-branded strategies, mostly in the corporate bond space. Indeed, ESG-type factors - particularly governance - are often already considered by corporate debt investors who do not necessarily brand their work under the banner of sustainability. This is particularly true in the case of corporate bonds in emerging markets, where governance considerations can pose significantly greater risks. Separately, we note with interest a rise in what might even be called “thematic” public fixed income, particularly with the issuance of an increasing volume of “green bonds” used to fund environmentally friendly projects.

That being said, with reference to the "evolution" story presented earlier in this section, we do not observe similar potential for movement from integration towards "impact" over time in the fixed income space.

The shareholder will always have more influence and more mechanisms for exerting their influence than the bond investor. Whilst the latter is capable of driving meaningful change, it appears likely that pre-investment assessment (whether through integration or screens), monitoring and divestment will continue to sit at the core of ESG fixed income.

Whilst these developments have occurred, the industry appears to have become more, rather than less, fragmented in its approach to ESG. We have not observed the development of greater uniformity, even within listed equity.

For the investors that bring deeply held, differentiated views on responsible investment to the table - and there will always be many - customisation will continue to be crucial. Yet we also speak with investors around the world that have simply copied the ESG policy of recognised leaders, most notably the Norwegian oil fund, despite the fact that it is evidently not a "one size fits all" model. Some managers have done the same, in part to enable them to sell pooled funds into the Nordic market more effectively.

For asset owners that simply wish to follow a version of "best practice" consistent with their fiduciary responsibilities, or are under pressure to demonstrate their ESG commitment effectively, a more prescriptive form of leadership from respected, recognised bodies such as PRI may be welcome. Parts of the investor and manager landscape may appreciate some degree of standardisation.

Three Takeaways

When rating or scoring managers on ESG issues, an approach that is specific to the individual investor can significantly increase the universe of providers from which that investor can choose.

Culture, attitude and internal organisational conflicts of interest can outweigh formal processes and practices where ESG matters are concerned. Avoid giving excessive weight to signs of commitment that may be superficial.

ESG integration should not, in theory, involve increased fees. That being said, the frequent need for customisation - even among investors that would prefer pooled fund structures - can add an extra layer of cost to ESG investment.

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