SRI and fund manager due diligence - Making sure your manager walks the talk

APAFS Webinar

David Rae, January 2021

Purpose

Holding your managers' feet to the fire

This webinar aims to help you have a conversation with your investment managers, advisers and consultants on what they are doing about Socially Responsible Investing (SRI or ESG).

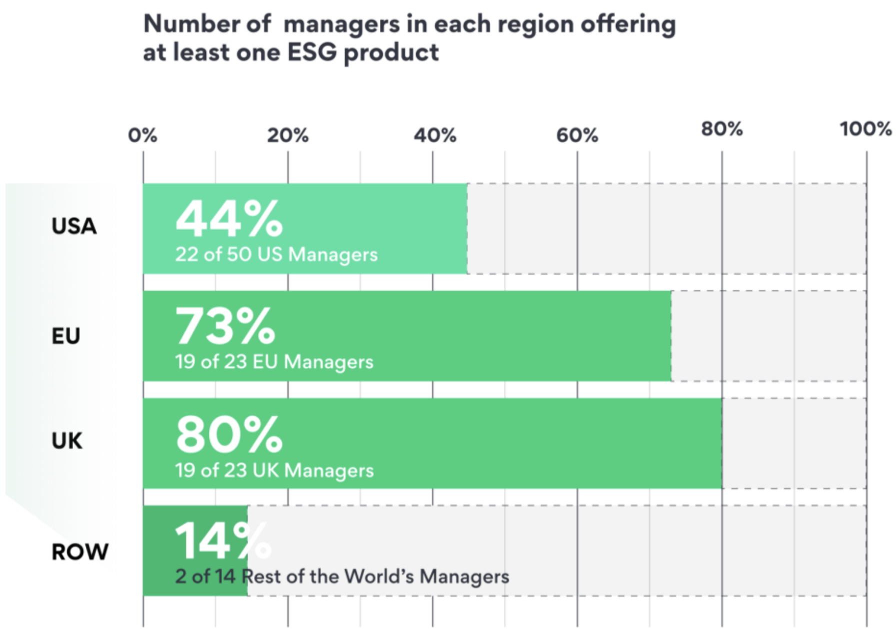
We aim to show you what deep integration of SRI looks like, and what the SRI leaders are doing.

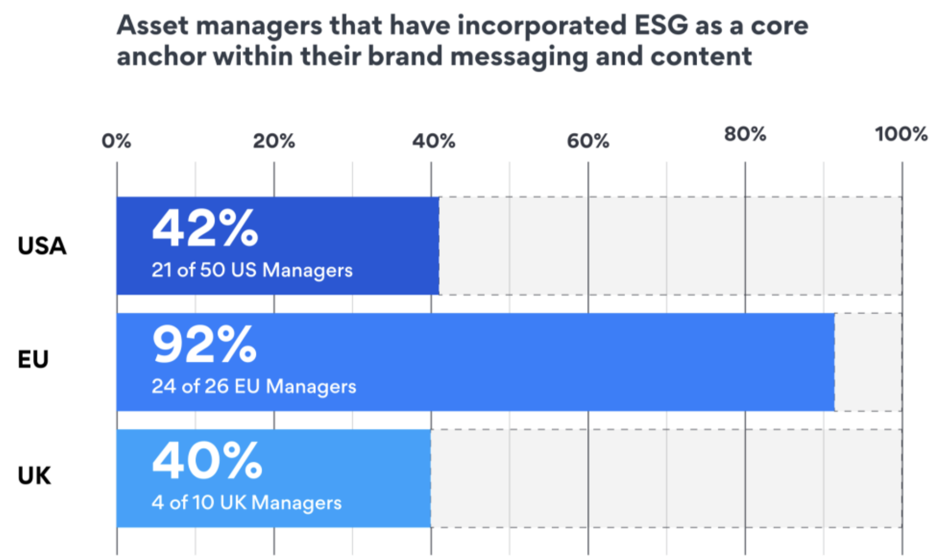
Our approach is to give you questions that you can ask your manager, so that you have a productive conversation. These are in the nature of face-to-face questions but they could be modified to form a written due diligence questionnaire .

There are no right and wrong answers to most of these questions. But, they will help you uncover who is trying harder and who is just paying 'lip service' to SRI issues.

SRI in a global context

Fund managers in Europe and Australasia are further ahead than those in the United States





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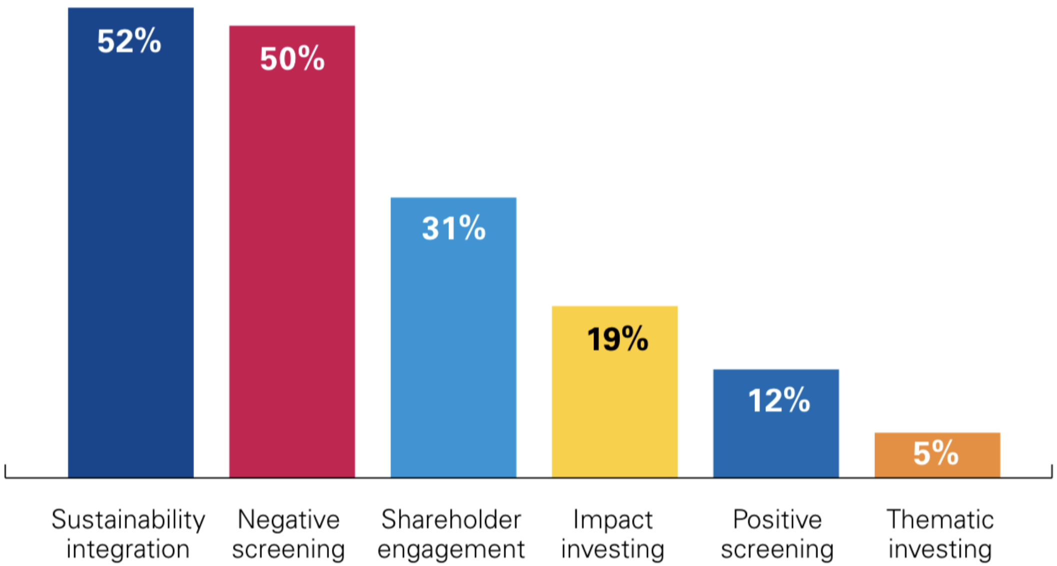
SRI in a global context

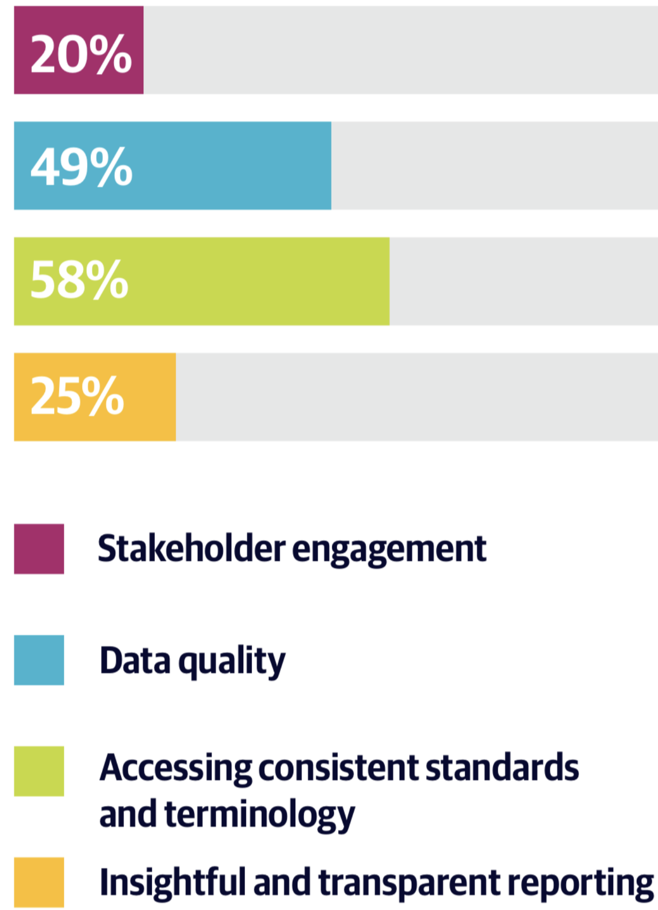
Negative screening is common but so too is 'integration'

Figure 1.5 Which of the following best describes your organization's strategy when it comes to ESG?



Source: KPMG–CAIA–AIMA–CREATE Survey 2020

What are the key challenges to embedding ESG in the organisation?



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The spectrum of Responsible Investing

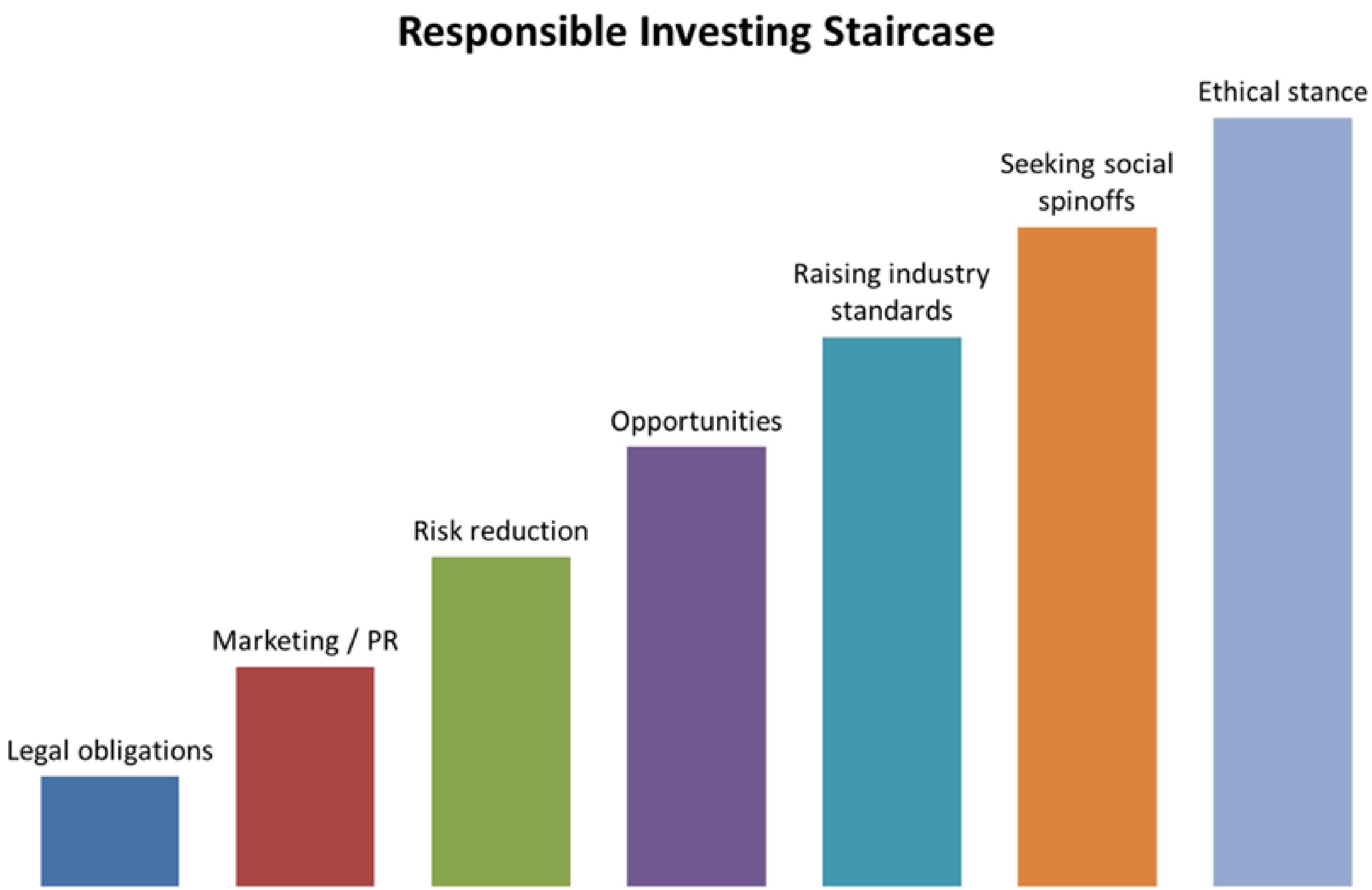
Table 1. The spectrum of social and financial investing

	Philanthropy		Social Impact Investing		Sustainable and Responsible Investing[8]	Conventional financial investing
	Traditional Philanthropy	Venture Philanthropy	Social Investing	Impact investment	ESG investing	Fully commercial investment
Focus	Address societal challenges through the provision of grants	Address societal challenges with venture investment approaches	Investment with a focus on social and/or environmental outcome and some expected financial return	Investment with an intent to have a measurable environmental and/or social return	Enhance long-term value by using ESG factors to mitigate risks and identify growth opportunities.	Limited or no regard for environmental, social or governance practices
			Use of ESG metrics and methodologies			
Return Expectation	Social return only	Social return focused	Social return and sub-market financial return	Social return and adequate financial market rate	Financial market return focused on long-term value	Financial market return only
	Social impact	←→	Social and financial		←→	Financial returns

Source: stylised adaptation from OECD (2019), "Social Impact Investment, the Impact Imperative for Sustainable Development," based on earlier versions from various organisations; for illustrative purposes only.

The spectrum of responsible investing

Where on the staircase are you as an asset owner?



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Context – what issues should you focus on?

Figure 6. SASB materiality map

Environment
- GHG Emissions
- Air Quality
- Energy Management
- Water & Wastewater Management
- Waste & Hazardous Materials Management
- Ecological Impacts

Social Capital
- Human Rights & Community Relations
- Customer Privacy
- Data Security
- Access & Affordability
- Product Quality & Safety
- Customer Welfare
- Selling Practices & Product Labeling

Leadership & Governance
- Business Ethics
- Competitive Behavior
- Management of the Legal & Regulatory Environment
- Critical Incident Risk Management
- Systemic Risk Management

Business Model & Innovation
- Product Design & Lifecycle Management
- Business Model Resilience
- Supply Chain Management
- Materials Sourcing & Efficiency
- Physical Impacts of Climate Change

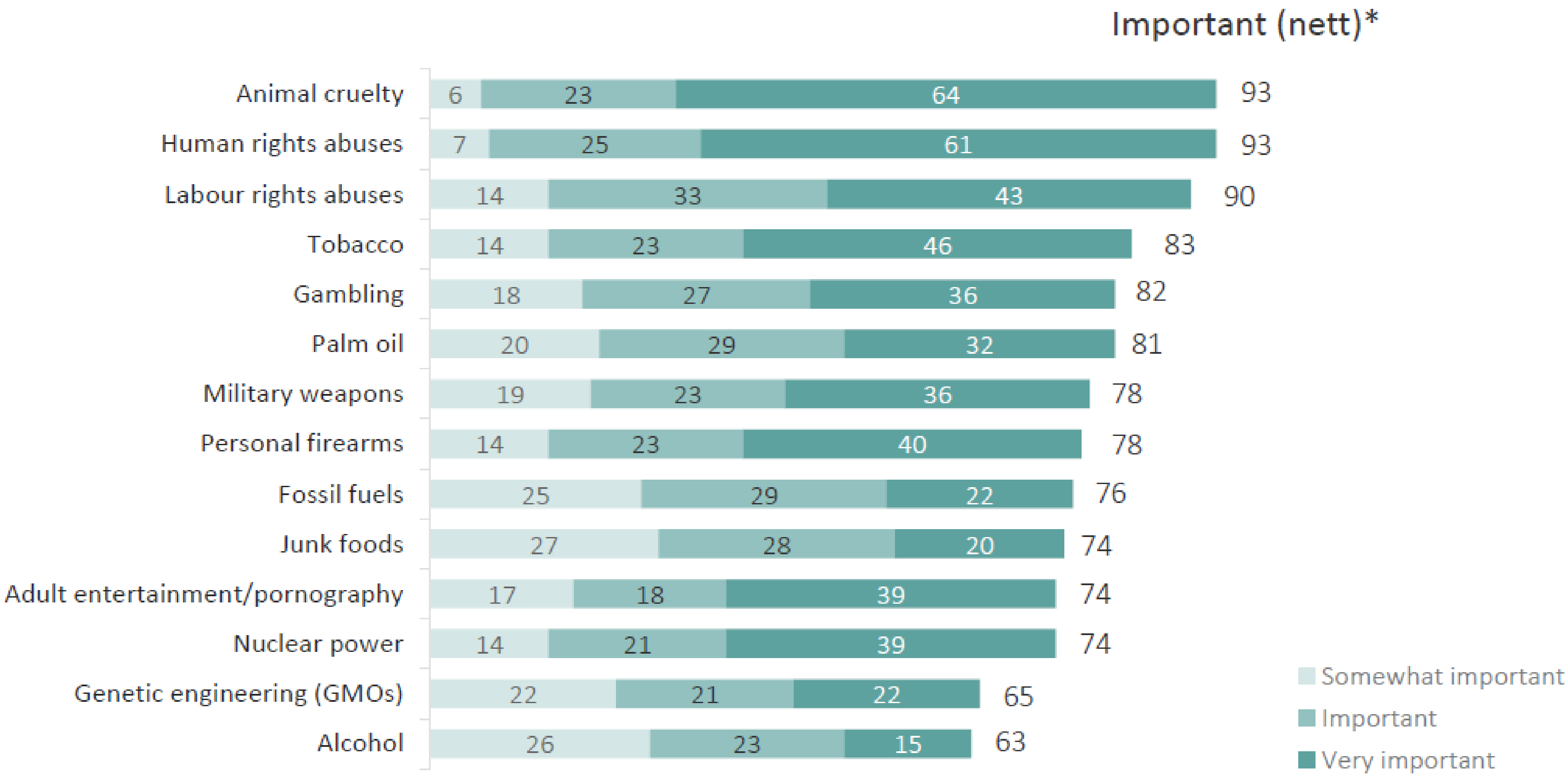
Human Capital
- Labor Practices
- Employee Health & Safety
- Employee Engagement, Diversity & Inclusion

Source: SASB website, provided for illustrative purposes.

Which of these is material?
How do we know?
How confident are we?

Context – what issues do owners care most about?

(New Zealand KiwiSaver investor survey)



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SRI integration – what does good practice look like?

Only a few managers have gone beyond basis SRI 1.0. Full integration is hard.

SRI 1.0

Become a signatory to the PRI

Exclude the standard sectors – tobacco, controversial weapons

SRI 2.0

Full integration into the investment process

Active ownership – voting, engagement with companies

Seeking out positive opportunities

Portfolio weights are affected by ESG views / scores

Across multiple asset classes, not just equities

ESG factors built into valuation models

SRI training. Part of company culture

Data-based reporting on what the manager has done

Binary exclusions are a last resort

Conversation starters

Start with some big open-ended questions. Dig into the details later.

In what ways has SRI changed the portfolio, or changed your buy/sell decisions?

What do you differently now as a firm, compared with say five years ago, because of SRI?

What are you most proud of or what has been your biggest success when it comes to SRI?

What are the big gaps? What else do you need to do over the next five years to get SRI better integrated into your decision making?

Integrating SRI into the investment process – people and culture

These questions will help uncover how deeply embedded SRI is, or whether it's 'out to the side'

Who does the SRI stuff in your firm?

Who does she report to? Where does she sit?

How does SRI fit into the due diligence process?

What training do the investment staff have in SRI?

How do you monitor your SRI activities? Where do those reports go (Investment Committee, Board?)

Look for

- Firms that have an SRI expert or team, but …
- … the SRI is 'done by' portfolio managers, not just left to the SRI unit
- SRI team is part of the investments team, not back/middle office
- All investment staff having to do SRI training
- Prominent on the website

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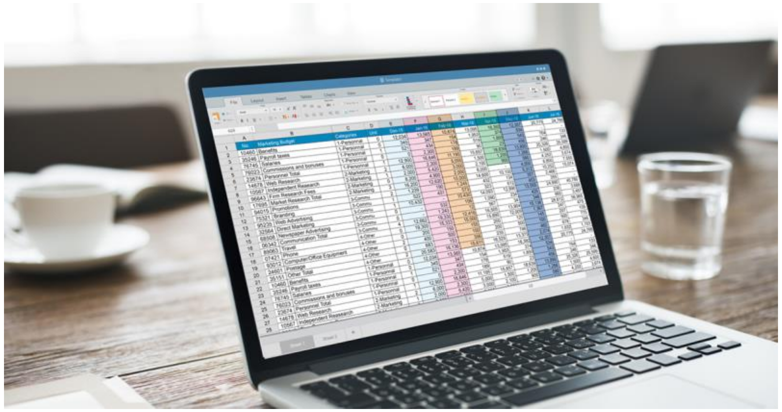
Integrating SRI into the investment process – investment tools

How does SRI alter the tools and processes of decision making?



Are SRI issues incorporated into your valuation models, e.g. DCF models?

How do SRI metrics feed through to investment sizing decisions?

Apart from equities, which other asset classes do you apply SRI to? What do you do for fixed income, real estate, infrastructure…?

What SRI metrics do you use? Where do you source the data from? How much is based on your investment team's judgement?

How do you measure whether SRI factors really are altering your investment decisions?

Look for

- SRI issues being included in valuation models
- SRI issues affecting position sizing in a systematic way
- Firms that subscribe to an ESG data service
- Firms that are applying SRI to more than just equities. SRI leaders are putting more effort into fixed income but realistically, progress beyond that is limited.

Active ownership - voting

Managers should vote your shares in a systematic and thoughtful way

Look for

- Always voting
- Vote 'against' on more issues than just Remuneration
- Willing to over-ride the proxy voting agent's recommendations
- A written voting policy

Open Ended Question

- What is your approach to voting our shares?

Follow up Questions

- Do you use a proxy voting agency? Why did you choose that one?
- Do you always vote, or only sometimes?
- Who makes the voting decisions in your firm?
- How often do you vote against management? On what sort of issues?
- Can you give some examples? Do you have data on your voting record?

Active ownership - engagement

Talking with companies is better than exclusions – but is resource intensive and takes time to pay off

Open Ended Question

- How do you engage with companies?

Follow up Questions

- What are the key SRI issues that you have engaged on?
- Do you team up with other managers/investors?
- Have you engaged on modern slavery and related supply chain issues?
- Do you think it works? How do you measure success?
- Who does the engagement?
- Do you use an external engagement service, like F&C? If not why not?

Look for

- SRI engagement at C-suite level (not the Head of Investor Relations)
- SRI engagement carved out separately, not just a brief few minutes at the end of the conversation with the CFO
- Managers engaging on more than traditional corporate governance issues – especially new issues like modern slavery.

Exclusions

Negative screening is the easiest, most common, and probably least effective step that can be taken

Look for

- Exclusions or negative screening being a small part of what they do
- Clear framework for deciding when to exclude a company or sector
- Firms that are willing to exclude individual companies (e.g. a gold miner with a poor environmental record)

Open Ended Question

- What is your approach to exclusions?

Follow up Questions

- Which sectors are excluded? Who decides this, and what criteria do you use?
- Do you exclude companies mostly for ethical or financial reasons?
- Have you excluded any individual companies purely for 'bad behaviour' – can you give any examples?

Positive investments, thematic investing

Can be upweighting good ESG scorers; or investing in ‘best of class’ companies; or picking themes

Open Ended Question

- What is the best way to increase the portfolio weighting on the best ESG performers?

Follow up Questions

- Do you use a top-down ‘thematic’ approach? If so, how does that work and how does it feed through to investment decisions?
- What do you think about systematically tilting the portfolio based on ESG scores – down-weight the low-scoring firms and up-weight the high scorers?

Look for

- A well thought out framework, not just ‘random’ decisions (“oh, we invest in renewable energy and that counts as a positive investment”)

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