

# MERCER

Investment Consulting

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## **Significant Factors Impacting Capital Markets**

*Integrating environmental, social and  
corporate governance factors into investment  
decisions.*

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Marsh & McLennan Companies

# Agenda

- ESG integration and responsible investment
- Evolution of ESG integration
- The future of ESG integration and RI
- Barriers and opportunities for institutional investors



# **ESG integration and responsible investment**

## Drivers for mainstreaming responsible investment

# Why investors consider ESG factors

What is driving the process of “mainstreaming”?

- A growing body of literature suggests that performance on ESG factors **can impact stock price**
- RI proponents argue that indications of superior ESG performance can be a **proxy for good management** and a source of superior financial performance
- Environmental and social issues are of increasing **concern to society**, non-governmental organizations and governments (e.g. G8 focus on climate change). Corporations with poor reputations in this regard may suffer financially
- Investors are becoming more engaged as a mechanism for **policing the corporate sector** in a global economy
- The Principles for Responsible Investment and the “Freshfields Report” are addressing issues of **fiduciary duty**
- There is still a desire among many institutions to **align core values** with investment decision-making.

# What are the ESG issues impacting value?

## Some examples

- **Climate change**: Under one scenario capital requirements of the insurance industry could increase by over 90% for US hurricanes, around 80% for Japanese typhoons, and at least 5% for European windstorms. An additional US\$78 billion could be needed to cover the gap between extreme and average losses. (Source: ABI)
- **Executive compensation**: US\$640 billion in shareholder value lost at 11 companies whose CEOs collected US\$865 million in the same timeframe. (Source: The Corporate Library)

What's the next big **risk**?: SEC investigates IMAX, BP slows production in Alaska, DuPont fined and sued over Teflon, targeted Sudan investment is now a national campaign in the US

What's the next big **opportunity**?: GE doubles estimates for investment and return on clean tech products. WAL-MART goes green and friendly. Honda to release more efficient hybrid engine



## **The evolution of ESG integration**

# The evolution of Responsible Investment (RI)

**Ethical Screening**

**Risk Management**

**Enhancing returns**

- Systematic avoidance of investment in targeted companies, industries or countries. Results in narrowed investment portfolio choices. **Screened approach.**
- Companies or sectors are over-weighted if demonstrate responsible leadership and under-weighted where evidence of environmentally & socially irresponsible practices. Active ownership policies are implemented. In theory, downside risk can be reduced. **Best of sector or engagement approach.**
- Superior environmental, social and corporate governance (ESG) performance is considered a source of alpha for RI investors. Analysis of ESG factors provides opportunity to outperform traditional investors who lack it. **Engagement or integrated approach.**
- Clean tech funds, green REITS, RI hedge funds, governance-focused private equity funds. **Focused assets approach.**

## **RI trends in action:**

### Recent developments in ESG integration - 2004

- The UNEP Financial Initiative’s Asset Management Working Group commissions 11 sector studies from leading asset managers. Goldman Sachs concludes: *“Environmental and social issues count... we believe such issues are part of the relative quality of overall management performance needed to compete successfully.”*
- Enhanced Analytics Initiative (EAI). Members with assets totalling more than US\$1 trillion agree to allocate a minimum of 5% of their broker commissions to extra-financial research.
- Pharmaceutical Shareowners Group formed in Europe. Seeks to use its influence as investors to constructively engage the industry from a business perspective. Publishes *“The Public Health Crisis in Emerging Markets: An Institutional Investor Perspective on the Implications for the Pharmaceutical Industry.”*

## **RI trends in action:**

### Recent developments in ESG integration - 2005

- Freshfields, Bruckhaus, Deringert, the worlds third largest law firm, concludes “Far from preventing the integration of ESG considerations, the law clearly permits and, in certain circumstances, requires that this be done.
- UBS presents framework within which companies may consider corporate social responsibility activities. Author concludes that “social risk is a form of business risk.”
- Sales of Toyota Prius increase 250% from previous year and General Electric launches its “ecoimagination” program, planning to double investment in and revenue from clean technology over the next 5 years.

## **RI trends in action:**

### Recent developments in ESG integration – 2006 so far

- Marsh, parent company to Mercer Investment Consulting, releases a “Risk Alert” on climate change identifying risks, opportunities and tools for addressing potential exposure to climate change. AIG releases operating policy on climate change, first in insurance industry.
- Institutions representing assets of over US\$2 trillion launch the Principles for Responsible Investment (PRI) at the New York Stock Exchange. Mercer IC was the consultant engaged to assist in development of Principles. Now 50+ signatories representing over US\$5 trillion.
- UNEP Finance Initiative Asset Management Working Group releases second ESG materiality report with 12 sector studies. Results reflect that ESG issues are material to performance, materiality can be valued and quantified, material ESG issues are becoming more apparent, and their importance can vary between sectors.



## **The future of responsible investment**

What do investment managers and institutional investors think?

# What do investors think about responsible investment?

Survey results uncover industry trends

- ***Perspectives on Responsible Investment:*** Recent survey of 183 US institutional investors, ranging in size from under US\$250 million to over US\$5 billion in assets
  - Participants included:
    - Defined benefit and defined contribution corporate and public pension funds; not-for-profits (foundations, endowments, charities, health care organizations, and religious groups)
  - Available at [www.merceric.com/usrisurvey](http://www.merceric.com/usrisurvey)
- ***2005 & 2006 Fearless Forecast: What do Investment Managers Think About Responsible Investment?***
  - Participants included 157 investment firms from around the world managing assets in excess of US\$20 trillion
  - Available at [www.merceric.com/riforecast](http://www.merceric.com/riforecast)

# Environmental, social & corporate governance factors and investment performance

## Views on the materiality of ESG factors

### Investment Managers

- Corporate governance is currently important **BUT** environmental issues (water & climate change) will grow in importance
- Shorter term: Globalization, corporate governance & terrorism
- In five years: Globalization, corporate governance, climate change & use of/access to clean water

### Institutional Investors

- Corporate governance is currently considered most important (64%)
- Sustainability (39%) and employee relations (33%) follow
- Environmental management and climate change are expected to increase most over five years

# Integrating environmental, social & corporate governance factors into investment decisions

Expectations for mainstream and specialist products

## Investment Managers

- 15% (35% in 3 years) expect increased client demand for mainstream investment products that consider ESG factors
- 13% (35% in 3 years) expect increased demand for specialist ESG products

## Institutional Investors

- 75% believe ESG factors are material to investment performance
- 29% and 31% intend to assess whether their internal and external asset managers are considering ESG factors

75% of institutional investors believe ESG is material but only 35% of managers are expecting an increase in demand for ESG analysis.

# Active ownership

## Expectations for proxy voting and shareholder engagement

### Global Investment Managers

- 80% predict active ownership will become a mainstream investment practice within 5 years (89% in 10 years)

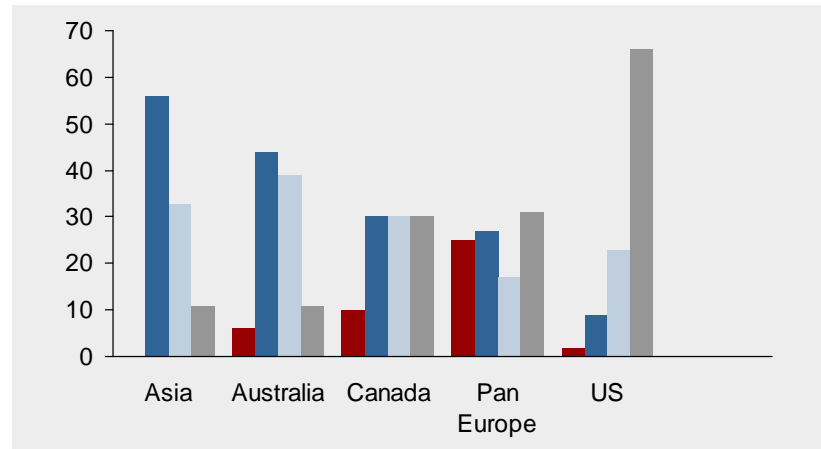
### US Institutional Investors

- 24% expect to increase proxy voting (over next 2 years)
- 27% plan to increase shareholder engagement

# What do investment managers think?

## Most investment managers see ESG as a trend

**Positive or negative screening for social or environmental factors**

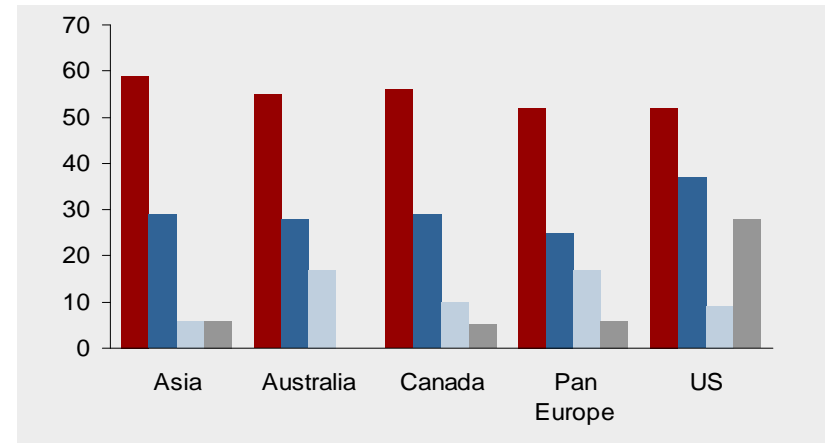


- Over next 1-2 years
- Over next 3-5 years
- Over next 6-10 years
- Never

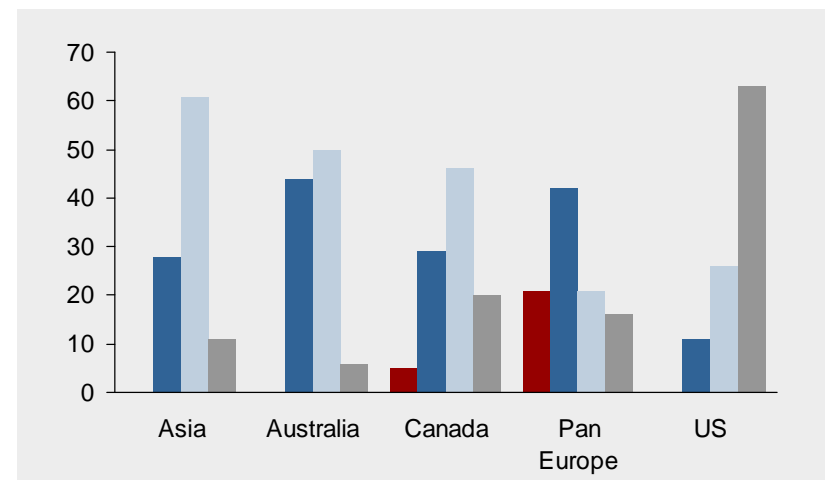
65% in US: ESG integration will never happen

65% in Europe: ESG integration will be mainstream in 1-5 years

**Active ownership (shareholder engagement/activism, proxy voting)**



**The integration of social/environmental corporate performance indicators**





# **Barriers and opportunities for institutional investors**

# ESG integration

## Barriers are still lurking...

- Investment trustees deal with a **range of issues and responsibilities**, and have only a limited amount of time
- Confusion around **terminology**
- There continues to be an assumption that consideration of ESG issues will **hurt financial returns**, rather than protect them
  - This leads to a concern that RI is a **breach of fiduciary responsibility**
- Lack of best-practices on **how** to develop and implement RI practices and ESG integration...
- How to **quantify the benefits** of ESG integration
- Reconciling **short-term reporting** with longer-term investment horizons
- Hedge funds, mutual funds and PE **present hurdles** for ESG integration and active ownership

# RI implementation options

## Considerations and approaches

### Factors to consider

- View on materiality of ESG issues
- Size, structure and current RI status
- RI positioning of peer group
- Stakeholder interests, issues and opportunities
- Corporate social responsibility commitments and/or organizational mission
- “Branding” and marketing perspective

### Possible approaches

- Develop RI policy and action plan
- Benchmark against peers
- Review current investment managers’ ESG practices
- Select a traditional manager with good “ESG rating”
- Select a specialist ESG product
- Review approach to proxy voting and shareholder engagement
- Support the UN Principles for Responsible Investment
- Develop external communications strategy on RI

# Opportunities for institutional investors

## Implementation options

- Types of RI and associated activities are not mutually exclusive, and there is no “one-size fits all” approach
- Integrate ESG factors into investment policy, mandates and monitoring processes: create a careful, thoughtful program based on YOUR objectives
  - Educate (Board, Committees, Members)
  - Examine (Policies, Managers, Portfolios)
  - Execute (Engagement, Investments, Initiatives)