Sustainable Investment and ESG:

The past, the present and the future

To consider and discuss asset owner perspectives on the past, present and future of sustainable investment, FTSE Russell hosted an asset owner roundtable in London on 6 December 2016. This panel formed part of a high profile event to celebrate the 15th anniversary of the FTSE4Good Index Series and the launch of the ESG Ratings data model on FTSE Russell's online client analytics platform (QSD).

The panel was chaired by Amanda Young (Head of Responsible Investment, Standard Life Investments, UK) and the speakers were Wan Kamaruzaman (CEO, KWAP, Malaysia), Jack Ehnes (CEO, CalSTRS, USA), and Mark Thompson (CIO, HSBC Bank UK Pension Scheme, UK).

Left to right:

Amanda Young, Head of Responsible Investment, Standard Life Investments (UK)

Wan Kamaruzaman, CEO, KWAP (Malaysia)

Jack Ehnes, CEO, CalSTRS (USA)

Mark Thompson, CIO, HSBC Bank UK Pension Scheme (UK)

FTSE4Good Index Series

The FTSE4Good Index Series is designed to measure the performance of companies demonstrating good environmental, social and governance (ESG) practices and performance.

The past

The world of sustainable investment and ESG has changed dramatically in recent years. Fifteen, or even ten, years ago, relatively few companies disclosed information on environmental, social and governance (ESG) issues. The information provided tended to be of limited value to investors; data was not comparable, data was not consistently calculated, and underlying assumptions were often unclear.

Even though some asset owners and asset managers proactively accounted for ESG issues in their investment practices and processes and in their engagement with companies, most paid relatively little attention to these issues. This lack of interest was reflected in companies' attitudes; in response to requests for information from investors or research organizations, they often asked why investors were asking these questions and whether investors would actually use the information in their investment decision-making.

"When FTSE4Good was first launched, press controversy surrounded the exclusion of Tesco from the Index. Yet, at the same time, investor requests for a meeting with Tesco to discuss its approach to corporate responsibility had been treated in a dismissive manner by the company. We certainly would not get the same response today! FTSE4Good was instrumental in making companies sit up and recognize that they needed to do much more in terms of their reporting to and dialogue with investors."

Amanda Young
(Head of Responsible Investment, Standard Life Investments)

The panellists acknowledged that, with the wisdom of hindsight, they would have done many things differently. The enthusiasm for social or environmental investment led to some investments being made without having access to enough information, or without having all of the tools they needed to fully assess these investments. While this created many valuable opportunities for 'learning by doing', it also meant that at least some of the decisions made were suboptimal, as investors did not have a complete picture of the social and environmental factors and data that were needed.

"One of the biggest changes we have seen has been the significant improvement in the quality and quantity of ESG information. The ESG-related data and information provided by FTSE Russell and its industry peers is of so much better quality than the data we had ten years ago, making it much easier to make sensible, well-informed investment decisions."

Jack Ehnes (CEO, CalSTRS)

Better ESG disclosures and the availability of tools such as the FTSE4Good Index Series and FTSE Russell's ESG Ratings also enable asset owners to take a much more analytical approach to assessing their fund managers. For example, Mark Thompson, reflecting on the evolution of HSBC Bank UK Pension Scheme's interactions with its fund managers, commented that the data and portfolio analysis tools provided by organizations such as FTSE Russell enable them to ask challenging questions to investment managers on exactly how ESG considerations were actually being taken into account by its investment managers.

"One of the key changes we have made has been to deepen our analysis of what our investment managers do. A number of years ago, we changed our approach from one where we asked our investment managers to present at our trustee meetings to one where we meet our investment managers at their premises, usually at least once a year. This allows us to have ESG issues on the agenda and to have a structured, detailed discussion about these issues and how they affect investment strategy."

Mark Thompson (CIO, HSBC Bank UK Pension Scheme)

As they reflected on the progress they and others have made over the past fifteen years, the panellists pointed to the critical role played by industry pioneers and by the service providers who developed the tools and products that enabled the investment industry to take account of ESG issues in their investment decisions.

The present

Investors are now widely recognized as key consumers of corporate ESG disclosures. Panellists observed that many routinely consider ESG-related data in their investments, to identify and assess the risks and opportunities presented by, for example, stranded assets, changing weather patterns and the transition to the low carbon economy.

"It is essential that investors practice what they preach. If we expect corporates to take specific actions – for example, having more independent directors on their boards or publishing pay data – then we should first do so in our own operations and activities."

Wan Kamaruzaman (CEO, KWAP)

"Geography is important. We have found a huge difference in the way our US and European fund managers address climate change in their investment practices and processes. While just 13% of our US managers say that they integrate climate change, the number is 61% for non-US managers."

Jack Ehnes (CEO, CalSTRS)

The panellists did not believe there was a conflict between the analysis of ESG issues and their fiduciary duties to their beneficiaries. Far from being a barrier to action, their view was that their fiduciary duties require them to analyze and take account of ESG issues in their investment decisions, given that these issues can enable material downside risks and upside opportunities to be identified and taken into account. However, how far advanced this thinking and approach was varied significantly across countries and regions.

Among leading asset owners, the use of ESG data is not confined to stock analysis but is increasingly integral to their overall portfolio management strategy. For example, Mark Thompson (CIO, HSBC Bank UK Pension Scheme) described how his trustees see climate change as a systemic risk, affecting all of the companies in their portfolio. As such, climate change is seen as relevant to benchmark design alongside more traditional smart beta factors such as volatility, size, quality and value. HSBC Bank UK Pension Scheme has worked with FTSE Russell and with Legal & General Investment Management to develop a multi-factor global equities index fund that incorporates the investment risks associated with climate change. This fund utilizes the innovative FTSE All-World Ex CW Climate Balanced Factor Index. This fund is now the default option for all HSBC Bank UK Pension Scheme's DC equity investments.

> “This new index is a tool that helps us to combine three climate parameters – carbon reserves, carbon emissions and green sector involvement - as input parameters. Our exposure to these factors can be dialled up and down, allowing us to significantly reduce our climate risks while also maintaining a very low tracking error against our benchmark index.”
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> **Mark Thompson** (CIO, HSBC Bank UK Pension Scheme)

Another notable development is the move towards the use of multiple approaches to sustainable investment. For example, recognizing the alignment between Shariah and ESG investment approaches, KWAP has made allocations to both, using the FTSE4Good Malaysia Index as a reference benchmark. In addition to these specific allocations, KWAP is working to integrate ESG issues in its investment portfolios across all asset classes. It is also building its internal capacity and understanding of ESG issues.

The future

All of the panellists agreed that the pace of change in this area was very fast. The increasing sophistication of the analytical tools and methodologies that are available, the better quality disclosures – in terms of accuracy, reliability, consistency and timeliness – that are provided by companies and the strengthening of investors' capacities and competencies will all facilitate this change.

These improvements will occur against a backdrop of stronger drivers for action. The panellists identified a variety of factors that were likely to create the conditions for change. They pointed to:

- Government, in its role as a regulator and as an enabler of change
- Increasing beneficiary interest in the impacts that their pensions can have on society and on the natural environment, the growing willingness of beneficiaries to press their pension funds to take action on these issues and the expectation that asset owners will be able to demonstrate the effectiveness of their engagement activities
- Millennials' interest in social issues and social purpose
- The role of stock exchanges driving high quality ESG disclosures
- The evidence that a focus on ESG issues can create investment value. For example, the performance data from indexes such as FTSE4Good and from funds such as the HSBC Bank UK Pension Scheme provide the credible evidence that is needed to convince CEOs and CIOs of the value of integrating ESG issues into their investment practices and processes
- Learning by doing. One example cited by the panellists was the clear evidence from the FTSE4Good Index Series that company engagement can lead to significant improvements in companies' ESG performance and, in turn, financial performance. This experience, and FTSE Russell's willingness to share its experiences and lessons learned, has encouraged and enabled asset owners and asset managers to engage with the companies that they are invested in

> “We must make pensions and investment interesting and relevant to the needs and to the values of younger members”.
>
> **Mark Thompson** (CIO, HSBC Bank UK Pension Scheme)

The challenges

However, there are challenges. Some of these are technical: in many cases the ESG data reported by companies is still not investment grade or is not reported at all, certain risks are difficult to measure, and it is not clear how much weight investors should give to ESG issues relative to other drivers of investment performance.

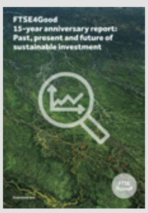
Some of the challenges relate to the structure of the investment industry, and the willingness of market participants to offer products that are distinctive and have high ESG convictions linked to a demonstrable investment thesis. Furthermore, asset managers do not offer the high quality ESG investment products that the end investors want. Also, asset owners, for defined contribution offerings need to shift their focus from adding green or socially responsible investment as alternatives and instead to consider the investment case and to offer more integrated and responsible products as a default.

Despite these challenges, the central conclusion from panellists was clear. Asset owners need to engage and consider ESG issues from both an investment risk and opportunity perspective. By focusing on these issues, they not only respond to the needs of stakeholders, but they can deliver investment strategies that better meet their beneficiaries' values and needs.

For more information

Watch the panel discussions.

Learn more about ESG indexes and analytics at ftserussell.com/esg



Download the FTSE4Good 15 year anniversary report.