

WINNING PRACTICES & INNOVATIVE APPLICATIONS

ESG – Environmental, Social and Governance Investment Criteria

- What is ESG?
- Is ESG just a buzz or a trend?
- How are managers different in their approaches/ Evolution of ESG
- Clarifying fiduciary obligations and due diligence of plan sponsors
 - DOL Field Assistance Bulletin No. 2018-01



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What is ESG?

Environmental



How a company uses and impacts the natural environment in its supply chain

Social



How a company manages relationships with its employees, suppliers, customers and the communities where it operates

Governance



Policies and practices related to a company's leadership, executive pay, and shareholder rights

Different approaches to ESG

Varying degrees of ESG consideration in investing styles:

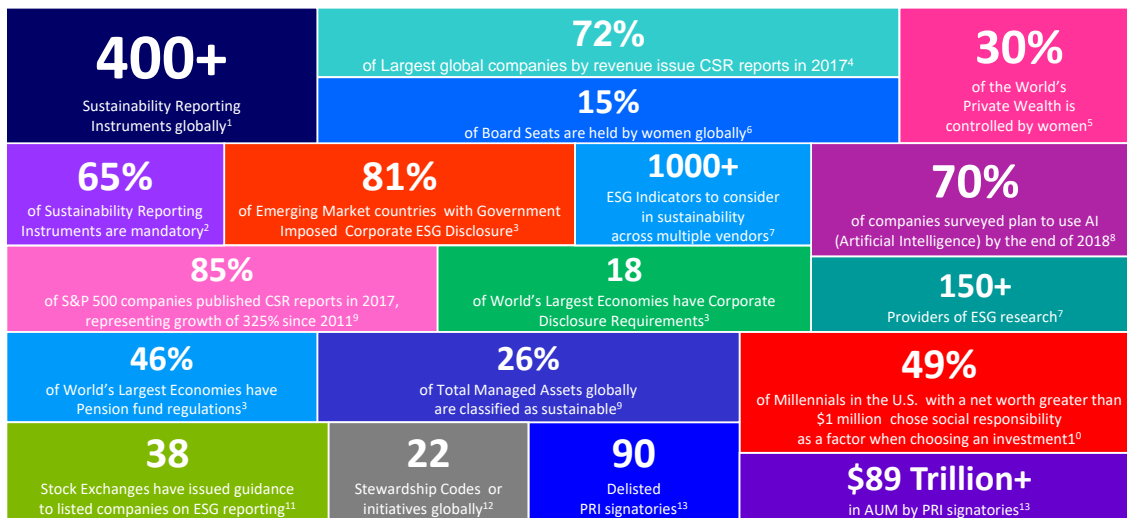
- Socially Responsible Investing (“SRI”)
- Religion-based screening
- ESG best-in-class
- ESG integration
- Thematic
- Engagement
- Impact
- Mission-based investing

*ESG best-in-class: including companies selected for positive ESG performance relative to industry peers and avoiding companies that do not meet certain ESG performance thresholds.
For Illustrative Purposes Only.*

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State of the Responsible Investment Industry



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Sources: (1) PRI responsible investment regulation database as of Aug 27, 2018 (2) Carrot & Sticks Global trends in sustainability reporting regulation and policy 2016 (3) PRU/MSCI Global Guide to Responsible Investment Regulation 2016 (4) KPMG Survey of Corporate Responsibility Reporting 2017 (5) Boston Consulting Group Global Wealth 2016: Navigating the New Client Landscape (6) Deloitte Women in the boardroom: A Global Perspective 5th Edition (7) Journal of Environmental Investing 8, No. 1 2017 Guide to ESG Data Providers and Relevant Trends (8) Forrester Research Predictions 2018: The Honeymoon For AI Is Over (9) GSIA 2016 Global Sustainable Investment Review (10) Spectrem Group High Net Millennials (11) Sustainable Stock Exchanges Initiative as of August 28, 2017 (12) EY Q&A on Stewardship Codes August 2017 (13) PRI Annual Report 2018

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Macro Thematic View of Responsible Investing



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Fiduciary Duty and ESG

Whatever is worth doing is worth doing well.

- Lewis Carroll (famous writer and mathematician)

Active fund managers have always considered ESG risks as part of a robust investment process.

The discussion around ESG today is not about fundamentally changing what we do, but rather creating a framework around these risks that can be clearly articulated, measured, monitored and tracked.



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The Road to ESG

Asset Managers face multiple challenges

Difficult To Implement

Performance Myths

Data Coverage

Incentives Misaligned

Additional Cost

Data Quality

Reporting Standards

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Have we forgotten someone?

Asset Owners, Asset Managers

Industry

Destination ?

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The UN Sustainable Development Goals (SDGs)

In September 2015, the SDGs were adopted unanimously by 193 heads of state and other leaders at a summit at the UN Headquarters in New York



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Source: United Nations

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ESG: Trends among plan participants

Over the past several years there has been **growing interest in investments** that align with investor's values

- Today's plan participants want investments that reflect their personal values:



- 82% want their investments to reflect their personal values*
- 62-72% of Millennials would contribute more if it advanced social good*
- 74% want more socially responsible investments in their retirement plan*

- Today's plan participants want to invest in companies that are doing the right thing



- 64% of all participants surveyed said they are concerned about the environmental, social and ethical records of the companies they invest in**
- 73% believe companies that provide clean water and clean energy present significant growth opportunities for their investments**

*Natixis Investment Managers, 2016 Retirement Plan Participant Study compiled by CoreData Research, August 2016. Survey included 951 US workers, 651 being plan participants and 300 being non-participants. The age groups are broken up as follows: 285 Gen Y/Millennials (18-34 years old), 283 Gen X (35-50 years old) and 383 Baby Boomers (51 years and older).

**Natixis Investment Managers, Global Survey of Individual Investors conducted by CoreData Research, February 2016. Survey included 7,100 investors in 22 countries, of which 750 were in the US.

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Department of Labor guidance as a reference

ERISA requires fiduciaries to:

- act with the care, skill, prudence, and diligence a prudent person would use
- act “solely” in interest of a plan’s beneficiaries and for “exclusive purpose” of providing benefits and paying reasonable administrative expenses

Collateral Benefits (CBs):

- economic benefits created apart from investment return to the plan (CBs created by “Economically Targeted Investments” or “ETIs”)
- DOL’s longstanding position: fiduciaries may not sacrifice investment returns or assume greater investment risks as a means of promoting collateral social policy goals
- Interpretative Bulletins issued on ETIs:



Why does ESG Matter?

Because a company’s **environmental actions** can impact:

- ✓ Operational efficiency and costs
- ✓ Environmental liability
- ✓ Opportunities for low-carbon revenue sources

Because a company’s **social behaviors** can impact:

- ✓ Effective management of human capital
- ✓ Risks related to product/service safety
- ✓ Reputation and trust with customer base

Because a company’s **governance practices** can impact:

- ✓ Long-term strategy and capital allocation decisions
- ✓ Financial and operational performance
- ✓ Regulatory liability

Potential Benefits of ESG Investing

Recent aggregated academic evidence is largely supportive of the ESG investment thesis

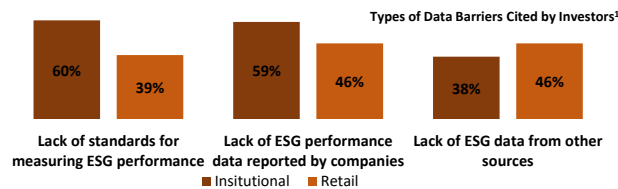
Cost of Capital	Operating Performance	Stock Prices
90% of studies on cost of capital show that high ESG scores lowers cost of capital	88% of studies show that strong ESG performance yields better operating performance of firms (e.g., ROA, Tobin's Q, etc.)	80% of studies show positive correlation between high ESG and superior stock performance

Source: From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance, March 2015, University of Oxford and Arabesque Partners. Retrieved 20 January 2016. The authors reviewed 29 cost of capital studies, 51 operating performance studies, and 41 stock price studies, respectively.

Factors Impacting Adoption

Data limitations, terminology confusion and measurement issues are primary concerns

Data Challenges



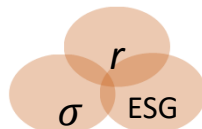
The primary barrier to effective ESG integration is the lack of standardized, high-quality ESG data to incorporate into investment decision making processes

Tradeoffs & Terminology



Clarifying ESG objectives and understanding terminology is essential for implementation. For example, "Sin stocks" may outperform² but may not align with investor values, while high ESG scores may signal future outperformance and reduced volatility in the long-term

Measurement & Benchmarking



Maximum risk adjusted return may not be the ultimate or sole objective — some investors have an expanded definition of performance

¹ Investing Enlightenment: How Principles and Pragmatism Can Create Sustainable Value Through ESG, Center For Applied Research, State Street Corporation. The study was conducted from November to December 2016. The findings are based on a global survey of 582 institutional investors across 29 countries and 750 individual investors across 24 countries, as well as more than 25 interviews with senior executives.

² Sources: Dimson, Marsh and Staunton (2015), Hong and Kacperczyk (2008), Blitz and Fabozzi (2017). Blitz and Fabozzi posit that outperformance is explained by quality factors rather than a risk premium from shunning by investors.

Why Does Asset Stewardship Matter?



ESG Investment Styles and Terminology

	Exclusionary Screening	Positive Screening	ESG Integration	Impact Investing	Active Ownership/ Stewardship
Definitions	Excludes companies, sectors or countries involved in activities that do not align with global standards or investors' moral values	Tilts portfolio toward: <ul style="list-style-type: none"> • Best-in-class companies on ESG measures • Companies with strong ESG momentum • Companies solving specific ESG Themes 	Incorporates ESG data, alongside traditional financial analysis, into the securities selection process	Targets a measurable positive social and/or environmental impact. Investments are generally project specific.	Voting company shares and engaging with companies on a variety of ESG issues to effect changes in behavior or company practices and policies
Common Objectives	Align portfolios with moral and ethical values Mitigate ESG risks Influence companies to change business models or stop certain practices	Mitigate ESG risks Achieve higher returns Support business models solving sustainability issues Improve or maximize a portfolio's ESG score	Mitigate ESG Risks Achieve higher returns	Generate and measure specific social and/or environmental benefits that aligns with purpose	Influence company strategy for long-term value creation Help management capture value and reduce risk Enhance ESG disclosure and practices
Investment Considerations	Introduces tracking error and potentially impacts performance	Securities selection is based predominantly on ESG scores/ratings — sourcing quality ESG can be a challenge	Sourcing quality ESG data. Securities selection is based on quantitative and qualitative assessment of ESG factors, requiring analyst expertise. A long-term mindset is necessary.	Investments may be illiquid and investment returns could aim to be below or at/above the market rate	A significant ownership stake is needed to exert influence. Resource intensive. Active ownership is crucial for index strategies.

ESG: Role of the Consultant

- **Consultant’s role is to ask the question:**
 - What are the assets/fund for?
 - Answer is not always to make more money or hit a number.
- **Consultant’s role is to assure all material factors are considered and evaluated.**
 - Factors considered within the “E” or the “S” may be material in assessing opportunities.
- **Consultant’s view:**
 - Constructive engagement of corporate management is a responsible and necessary act of fiduciaries.
 - Impact and return are not mutually exclusive concepts.

How Consultants Can Help Clients Implement ESG

Investment Policy

- Objectives
- Risk Management
- Selection Criteria
- Required Reporting

Manager Selection

- Philosophy
- Process
- Security Selection
- Risk Management

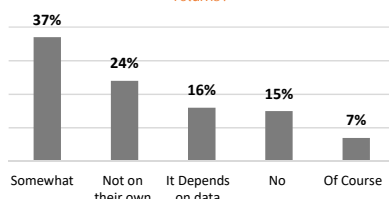
Proxy Voting

- Proxy Policy
- Annual Meetings
- Proposals
- Reporting

Corporate Governance

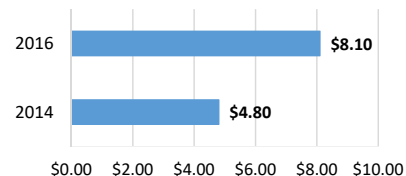
- Board of Directors
- Engagement
- Advocacy
- Alliances

CFA Institute Survey (Modified)
Do you think analyzing ESG factors can boost returns?



Source: CFA Institute Enterprising Investor: September 1, 2016

Asset Managers Considering ESG Criteria (Trillions)*



* Source: US SIF Foundation Biennial Report on U.S. SRI Trends, January 2017

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Questions?



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