Sewerage & Water Board of New Orleans

Chief Investment Officer's Presentation to the Pension Committee

May 8, 2018

May Meeting Agenda

- Delayed until June:
  - Presentation of Actuarial Valuation
  - Discussion of Draft Funding Policy
  - Discussion of amending Investment Objectives
- Professional Procurement Policy
- Governance Matrix
- Investment Philosophy

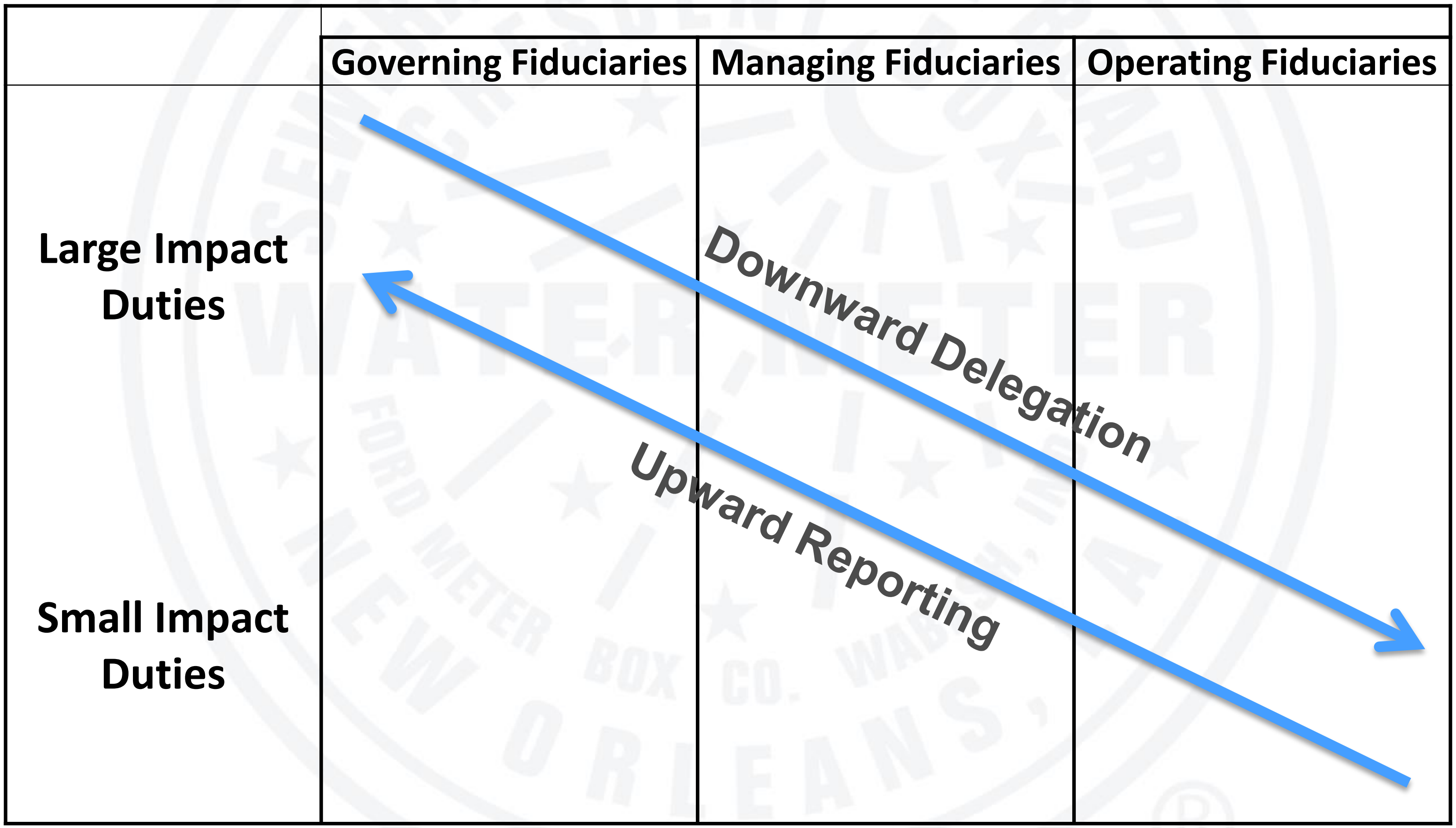
ERS Mission Statement

- ***Prudently manage an actuarially sound pension fund***
- ***solely in the interest of participants and beneficiaries***
- ***in a cost-effective manner.***

Governance

CLARIFYING DECISION RIGHTS

Basic Governance Structure



Adapted from: Keith P. Ambachtsheer and D. Don Ezra, Pension Fund Excellence, (New York: John Wiley & Sons, 1998) and John Ilkiw, Handbook on Asset-Liability Management: A Guide for US Fiduciaries, (Tacoma: Frank Russell Company, 1998).

Assigning Roles and Responsibilities

- Three Types of Fiduciaries
  - – Governing
  - – Managing
  - – Operating
- For each duty, three actions are assigned
  - – Decide – assigned to one unique party
  - – Oversee- assigned to one unique party
  - – Input

Delegation Overall

Delegate → ← Reporting

	ACTORS																					
				Governing Fiduciaries							Managing Fiduciaries					Operating Fiduciaries						
ACTIONS	Legislature	Courts	Mayor	S&WB Board of Directors	BOD Audit Committee	BOD Governance Committee	BOD Fin. & Admin. Committee	BOD Strategy Committee	ERS Board of Trustees	BOT Pension Committee	Executive Director	Special Counsel	Deputy Director Administration	Chief Investment Officer	Chief Financial Officer	General Consultant	Investment Managers	Investment Operations Consultant	Actuary	Custodian	External Auditor	Internal Auditor
Create Laws	D	O							I	I	I											
Interpret & Apply Laws		D		I					I			I										
Set Organizational Values			1	D				I	O		I											
Create Governance Structure of ERS		O	1			I			D	I	I			I	I							
Compose Rules & Regulations of ERS		O	1			I			D	I	I		I	I	I							
Design All Pension Benefits		O	1				I	I	D9	I	I		I	I	I	I			I			
Set Employer Contribution Rates		O	1				I		D	I	I		I	I	I	I			I			10
Set Employee Contribution Rates		O	1						D2	I	I		I	I	I	I			I			10
Set Investment Objectives		O	1				I		D	I				I	I	I						
Establish Enterprise Risk Management		O	1	O	I			I	D	I	I	I	I	I	I	I		I		I	I	10
Create ERS Budget		O	1						D				I	I	I							10
Set Risk Appetite & Risk Capacity							I		O	D				I		I						
Set Strategic Asset Allocation (SAA)									O	D				I		I						
Design Within Asset Allocation Strategies									O	D				I		I						
Appoint Executive Director			1	D					O													
Appoint Special Counsel			I	D					O													
Hire/Fire Auditor			1	D	I				O						I							
Adopt Investment Philosophy									O	D				I		I						
Set Performance Benchmarks									O	D				I		I						
Hire/Fire Actuary									O	D		3		3	3							10
Hire/Fire General Investment Consultant									O	D		3		3	3							10
Hire/Fire Investment Managers									O	D				I		I						10
Hire/Fire Custodian									O	D		3		3	3	I						10
Hire/Fire Special Consultants									O		D	4		4	4	I						10
Appoint & Supervise DDA, CIO, CFO				O5						O5	D											
Create Annual Plan & Objectives											O			D		I						
Rebalance Fund to SAA, Tactical AA										O				D		I						
Conduct Vendor/Manager Due Diligence										O				6		D						
Size Mandates Within Constraints										O				D		I						
Sign Pension-Committee Approved Contracts												O		D								10
Authorize Money Movements Within Fund										O				D								10
Authorize Money Movements In/Out of Fund															D							10
Effect Money Movements														O8	O8			D8		7		10
Act as an Extension of Chief Investment Officer														O		D						
Report Investment Performance										O				I		D						
Measure & Report Risk										O				I		D						
Report Investment Compliance										O				I		D						
Approve CAFR				D	I		I		O	I	I			I	I						I	10
Select Securities														O		I	D					
Vote Proxies														O		I	D					
Prepare Actuarial Valuation										O			I		I				D			
Custody Assets															O					D		
Perform Master Record Keeping															O					D		10
Audit Financial Records				O											I						D	10
Hearing of Appeals		O								D			I									
Communicate with Retirees									O	D			I	I								
Administer ERS Benefits									O	I			D									10
Communicate with Employees on Pension									O	I	I		D	I								

Statutory Governance

	Delegate →																	← Reporting				
	ACTORS																					
				Governing Fiduciaries							Managing Fiduciaries					Operating Fiduciaries						
ACTIONS	Legislature	Courts	Mayor	S&WB Board of Directors	BOD Audit Committee	BOD Governance Committee	BOD Fin. & Admin. Committee	BOD Strategy Committee	ERS Board of Trustees	BOT Pension Committee	Executive Director	Special Counsel	Deputy Director Administration	Chief Investment Officer	Chief Financial Officer	General Consultant	Investment Managers	Investment Operations Consultant	Actuary	Custodian	External Auditor	Internal Auditor
Create Laws	D	O							I	I	I											
Interpret & Apply Laws		D		I					I			I										

Board of Directors

ACTIONS	Delegate →																	← Reporting				
	ACTORS																					
				Governing Fiduciaries							Managing Fiduciaries					Operating Fiduciaries						
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Set Organizational Values			1	D				I	O		I											
Appoint Executive Director			1	D					O													
Appoint Special Counsel			I	D					O													
Hire/Fire Auditor			1	D	I				O						I							
Approve CAFR				D	I		I		O	I	I			I	I						I	10

Board of Trustees

	Delegate →																	← Reporting				
	ACTORS																					
				Governing Fiduciaries							Managing Fiduciaries					Operating Fiduciaries						
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Create Governance Structure of ERS		O	1			I			D	I	I			I	I							
Compose Rules & Regulations of ERS		O	1			I			D	I	I		I	I	I							
Design All Pension Benefits		O	1				I	I	D	I	I		I	I	I	I			I			
Set Employer Contribution Rates		O	1				I		D	I	I		I	I	I	I			I			10
Set Employee Contribution Rates		O	1						D2	I	I		I	I	I	I			I			10
Set Investment Objectives		O	1				I		D	I				I	I	I						
Establish Enterprise Risk Management		O	1	O	I			I	D	I	I	I	I	I	I	I		I		I	I	10
Create ERS Budget		O	1						D				I	I	I							10

Pension Committee

Delegate → ← Reporting

ACTIONS	Legislature	Courts	Mayor	S&WB Board of Directors	BOD Audit Committee	BOD Governance Committee	BOD Fin. & Admin. Committee	BOD Strategy Committee	ERS Board of Trustees	BOT Pension Committee	Executive Director	Special Counsel	Deputy Director Administration	Chief Investment Officer	Chief Financial Officer	General Consultant	Investment Managers	Investment Operations Consultant	Actuary	Custodian	External Auditor	Internal Auditor
	ACTORS																					
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Set Strategic Asset Allocation (SAA)									O	D				I		I						
Design Within Asset Allocation Strategies									O	D				I		I						
Adopt Investment Philosophy									O	D				I		I						
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Hire/Fire Investment Managers									O	D				I		I						10
Hire/Fire Custodian									O	D		3		3	3	I						10
Hearing of Appeals		O								D			I									
Communicate with Retirees									O	D			I	I								

Executive Director

ACTIONS	Legislature	Courts	Mayor	S&WB Board of Directors	BOD Audit Committee	BOD Governance Committee	BOD Fin. & Admin. Committee	BOD Strategy Committee	ERS Board of Trustees	BOT Pension Committee	Executive Director	Special Counsel	Deputy Director Administration	Chief Investment Officer	Chief Financial Officer	General Consultant	Investment Managers	Investment Operations Consultant	Actuary	Custodian	External Auditor	Internal Auditor
	Delegate →																	← Reporting				
	ACTORS																					
				Governing Fiduciaries							Managing Fiduciaries					Operating Fiduciaries						
Hire/Fire Special Consultants									O		D	4		4	4	I						10
Appoint & Supervise DDA, CIO, CFO				O5						O5	D											

CIO, CFO, HR

	Delegate →																	← Reporting				
	ACTORS																					
				Governing Fiduciaries							Managing Fiduciaries					Operating Fiduciaries						
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Rebalance Fund to SAA, Tactical AA										O				D		I						
Conduct Vendor/Manager Due Diligence										O				6		D						
Size Mandates Within Constraints										O				D		I						
Sign Pension-Committee Approved Contracts												O		D								10
Authorize Money Movements Within Fund										O				D								10
Authorize Money Movements In/Out of Fund															D							10
Administer ERS Benefits									O	I			D									10
Communicate with Employees on Pension									O	I	I		D	I								

Investment Consultants

	Delegate →																	← Reporting				
	ACTORS																					
				Governing Fiduciaries							Managing Fiduciaries					Operating Fiduciaries						
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Conduct Vendor/Manager Due Diligence										O				6		D						
Act as an Extension of Chief Investment Officer														O		D						
Report Investment Performance										O				I		D						
Measure & Report Risk										O				I		D						
Report Investment Compliance										O				I		D						
Effect Money Movements														O8	O8			D8		7		10

Operating Fiduciaries

	Delegate →																← Reporting					
	ACTORS																					
				Governing Fiduciaries							Managing Fiduciaries					Operating Fiduciaries						
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Vote Proxies														O		I	D					
Prepare Actuarial Valuation										O			I		I				D			
Custody Assets															O					D		
Perform Master Record Keeping															O					D		10
Audit Financial Records				O											I						D	10

Notes About Governance Matrix

1. Mayor has vote on the Board of Directors and Board of Trustees
2. Employee contribution rate decided by a majority vote of the Board of Trustees AND 2 of 3 Active Employee Trustees
3. Part of Proposal Selection Committee for pension/investment-related service providers excluding investment managers.
4. May assist Executive Director in an emergency.
5. Board of Directors have oversight on the hiring of DDA and CFO. Board of Trustees have oversight on the hiring of CIO.
6. CIO's due diligence proscribed in ERS Procurement Policy and focused at verifying and understanding consultant's recommendations.
7. Received authorized payee delegation annually from CFO to timely pay Investment Operations Consultant.
8. Investment Operations Consultant received annual authorized payee delegation from CFO, rebalance from CIO or General Investment Consultant.
9. Major benefit changes must be evaluated for impact on funding (actuarial or asset-liability study).
10. Internal audit checks for BoT compliance with procurement policy, ERM, Benefit Administration, and financial record integrity.

Update

PROFESSIONAL SERVICES PROCUREMENT POLICY

Comparison of Existing S&WB Procurement Policy and Proposed ERS Procurement Policy

Entity	Responsibility	Existing S&WB	Proposed ERS
Purchasing	Maintains all contracts. Posts RFPs. POC in RFP.	✔	✔
Proposal Selection Committee	RFP evaluation	✔ 5, may interview	✔ 5, different composition
General Consultant	Recommends investment managers to Committee	Yes – but undocumented in policy	Yes – documented in policy
Board Committee	Approve/Disapprove PSC/Consultant recommendation	Recommends to Board	Interviews, final approval/disapproval
Board	Approvals	Final approval/disapproval	Properly sets policy, ensures compliance, delegates
Executive Director	Handles emergency procurements	✔	✔
Board authorized signer	Executes contract	Board authorized	Board authorized - CIO
EDBP	Sets allocation	✔	Process proactively seeks inclusion but not allocation
Chief Investment Officer	On-site due diligence	None	Yes – CIO; reports back to PSC and Committee
	Disclosure	`✔	✔

Investment Policy Statement Discussion

INVESTMENT PHILOSOPHY

Investment Philosophy

- The goal of investing is to earn enough to meet your objectives.
- Understand what you can control (in descending order: costs, liquidity, risk, and returns).
  - While you cannot control returns, you can decide to buy low and sell high.
- We have met the enemy, and he is us.
- There are limits to prediction:
  - The future is unknowable, so diversify.
  - Market timing is generally unrewarding.
  - Markets don't just mean revert, they overshoot.
- There are trade-offs in investing:
  - More risk must be assumed to gain higher expected returns.
  - Excess returns and market efficiency are inversely related and often cyclical.
  - Too much capital is the enemy of good returns.
- Performance cannot be guaranteed, but there are some predictions:
  - Philosophy, processes, and organizational resources drive excess returns. Culture and alignment of interest can enhance or detract.
  - IR is a function of skills, breadth, and freedom.

Updates

OLD BUSINESS

Follow Up From April Meeting

- Director Peychaud requested that Dr. Viezer follow-up with Mr. Bergeron on the composition of the Proposal Selection Committee in the draft procurement policy.
- Ms. Edwards asked whether there would be a conflict of interest if Pension Committee members served on its Proposal Selection Committee.
- Director Johnson would like worst case scenarios included in Callan's asset-liability study.
- Director Peychaud wants the asset-liability study to consider the impact of all eligible employees retiring.
- Ms. Powell's question about the impact of a natural disaster upon the pension will be addressed by a special analysis by our actuary.
- Director Johnson asked for profiles of public pensions similar to ERS.
- Ms. Edwards asked for information on public pension handling of ESG.
- Dr. Viezer will ask our actuary to model the pension impact of lowering the discount rate.
- S&WB management will develop a workforce forecast for Callan to use in the asset-liability study.
- Mr. Conefry will analyze the impact of lowering the discount rate to 6.00%.
- Director Peychaud asked Dr. Viezer to distribute the reciprocity agreement between ERS and NOMERS.

NEW BUSINESS?

June Meeting Agenda

- Vote on
  - Governance Matrix – amend IPS
  - Investment Philosophy – amend IPS
- Presentation of Actuarial Valuation
- Discussion of Draft Funding Policy
- Discussion of amending Investment Objectives

Appendix A
CFA Institute's Code of Conduct for Members of a Pension Scheme Governing Body

1. Act in good faith and in the best interest of the scheme participants and beneficiaries.
2. Act with prudence and reasonable care.
3. Act with skill, competence, and diligence.
4. Maintain independence and objectivity by, among other actions, avoiding conflicts of interest, refraining from self-dealing, and refusing any gift that could reasonably be expected to affect their loyalty.
5. Abide by all applicable laws, rules, and regulations, including the terms of the scheme documents.
6. Deal fairly, objectively, and impartially with all participants and beneficiaries.
7. Take actions that are consistent with the established mission of the scheme and the policies that support that mission.
8. Review on a regular basis the efficiency and effectiveness of the scheme's success in meeting its goals, including assessing the performance and actions of scheme service providers, such as investment managers, consultants, and actuaries.
9. Maintain confidentiality of scheme, participant, and beneficiary information.
10. Communicate with participants, beneficiaries, and supervisory authorities in a timely, accurate, and transparent manner.

Appendix B
Committee & Board Decisions

I. **FOUNDATIONAL DECISIONS** (October 2017 – December 2017)

A. Clarify governance focus

- ✓ Amend the current IPS to reflect 2015 decisions.
- ✓ Adopt an ERS Mission Statement
- ✓ Adopt the CFA Code of Conduct for Members of a Pension Governing Body
- ✓ Adopt a resolution to strongly encourage BOT to adhere to LA RS 11:185 Trustee Education requirements starting September 2018.

B. Decisions needed to complete Asset-Liability Study By June 2018

5. Amend and prioritize investment objectives

- ✓ Hire Asset-Liability Consultant

C. Decisions needed to issue RFP for General Investment Consultant

7. Adopt Investment Philosophy
8. Agree upon an investment manager search process (based upon philosophy & policies)
9. Agree upon investment consultant duties and governance matrix

Appendix B
Committee & Board Decisions

II. <u>MAJOR DECISIONS</u> (May 2018 – September 2018)*

D. Preparation

10. Governance Matrix:
    a. Who decides (and how) benefits?
    b. Who decides (and how) employer contributions?
    c. Who decides (and how) employee contributions?
    d. Who decides (and how) investment policy?
11. Hire General Investment Consultant
12. Adopt Statement of Risk Capacity and Risk Appetite

E. The BIG THREE Decision-Making

13. Benefit Policy
14. Contribution Policy
    a. Employee
    b. Employer
15. Investment Policy – Asset Allocation

Appendix B
Committee & Board Decisions

III. <u>FORMALIZE CUMULATIVE DECISIONS</u> (September 2018 – December 2018)*

F. Update Documents

16. Amend Investment Policy Statement
17. Amend Bylaws
18. Amend Rules and Regulations

IV. <u>IMPLEMENT ASSET ALLOCATION</u> (September 2018 – March 2019)*

G. Portfolio Construction

H. Investment Managers

*Dates are tentative and subject to revision.

Appendix C
PRMIA Principles of Good Governance*

- Key Competencies
- Resources and Processes
- Ongoing Education and Development
- Compensation Architecture
- Independence of Key Parties
- Risk Appetite
- External Validation
- Clear Accountability
- Disclosure and Transparency
- Trust, honesty and fairness of key people

*Professional Risk Managers' International Association, 2009

Sewerage & Water Board of New Orleans

Re-Building the City's Water Systems for the 21st Century

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6 CIO's due diligence proscribed in ERS Procurement Policy and focused at verifying and understanding consultant's recommendations.
7 Received authorized payee delegation annually from CFO to timely pay Investment Operations Consultant.
8 Investment Operations Consultant received annual authorized payee delegation from CFO, rebalance from CIO or G.I. Consultant
9 Major benefit changes must be evaluated for impact on funding (actuarial or asset-liability study).
10 Internal audit checks for BoT compliance with procurement policy, ERM, Benefit Administration, and financial record integrity

PURPOSE

This purpose of this procurement policy is to provide a prudent and transparent process for procuring competent external professional services for the Employees' Retirement System ("ERS") of the Sewerage & Water Board of New Orleans ("S&WB").

BACKGROUND

The Board of Trustees ("BoT") of the ERS has adopted the CFA Code of Conduct for Members of a Pension Scheme Governing Body ("Code of Conduct"). This Code of Conduct requires trustees to take actions that are consistent with the mission of the ERS, which is "to prudently manage an actuarially sound pension solely in the interest of participants and beneficiaries in a cost-effective manner." Louisiana RS 11:3821 and the Code of Conduct together require trustees to act with prudence and reasonable care. Pension schemes typically hire experts to advise, direct, and implement trustee decisions. It is prudent and cost-effective to delegate certain responsibilities to external parties (e.g., investment managers, consultants, custodians, actuaries, etc.). Trustees can rely on these third-party service providers provided that the trustees have made reasonable and diligent efforts to:

- Determine that the service providers act with appropriate skill, competence, and diligence.
- Determine that third-party experts are independent and free of conflicts of interest and have proper incentives to act in the best interest of the fund participants.
- Ensure that the third-party experts' decisions have a reasonable and adequate basis and that the decision process is adequately documented.

Trustees must consider whether the position of the pension scheme is enhanced by any investment or action. They must place the interests of ERS participants and beneficiaries first before all other considerations. The Code of Conduct provides this guidance:

> "Trustees *may* consider the position of other stakeholders when carrying out their duties to the fund. If appropriate under applicable law, it is acceptable for a trustee to consider the impact that the investment of scheme assets may have – for example, creating jobs or stimulating industry in a local area – ***so long as the interests of the participants and beneficiaries remain paramount***." [Emphasis added]

One such consideration is the Sewerage & Water Board of New Orleans' Economically Disadvantaged Business Program ("EDBP"). This Procurement Policy will follow industry practices to ensure that EDBP firms have the opportunity to compete for business serving ERS while holding the best interests of the pension scheme as dominant when making professional services procurement decisions.

RESPONSIBILITIES

Board of Trustees: Approves and ensures compliance with the ERS Professional Services Procurement Policy.

Pension Committee: Selects and terminates external investment managers, custodians and external auditors (if different from that used by the S&WB), actuaries, external legal counsel, and other ancillary investment services and authorizes contract negotiations by Pension Committee resolution.

Chief Investment Officer ("CIO"): (1) may initiate the procurement process and draft Request for Proposals ("RFP"), (2) participates and leads the Proposal Selection Committee, (3) may conduct verifying on-site due diligence, (4) provides recommendations to the Pension Committee about hiring and firing third-party investment service providers, and (5) executes contracts with those providers selected by the Pension Committee.

General Investment Consultant ("Consultant"): Provides the Pension Committee with the best investment manager candidates from which the Pension Committee will choose. The Consultant's recommendation will be based upon what it believes in its professional judgment to be the best fit for the ERS portfolio structure and if an active manager, most likely to outperform its market in the future based upon drivers such as investment philosophy/strategy, process, resources and factors such as organization culture and alignment of interest. The Consultant may recommend investment managers for termination.

Proposal Selection Committee: Evaluates RFPs received for investment-related professional services excluding investment managers and provides its top-ranked candidates from which the Pension Committee will choose. These service providers include Consultant, investment operations consultant, custodian, actuary, external auditor, external legal counsel, securities lending, etc. The Proposal Selection Committee ~~should~~ may be composed of up to ~~three~~ five individuals with pension, investment, and/or financial knowledge and experience. The Proposal Selection Committee will be composed of: (1) the CIO, (2) the Chief Financial Officer ("CFO") or his/her designee, ~~and~~ (3) an attorney from the S&WB Office of Special Counsel. The Proposal Selection Committee may also include two Pension Committee members; ideally one member of the Board of Directos and one employee or retiree Trustee. If any of these positions are vacant, the Executive Director of ERS may appoint a professional from within or outside of S&WB. ~~with the consent of the Pension Committee.~~ The Pension Committee shall approve all substitutions of the mandatory members and Pension Committee members of the Proposal Selection Committee.

S&WB Purchasing Department: advertises and posts RFPs for non-investment manager services, collects and distributes responses to the Proposal Selection Committee. The S&WB Purchasing Department will maintain historical files on all contracts (investment managers and other third-party investment-related service providers). The contract files will contain all original documents submitted to the Proposal Selection Committee and Pension Committee.

S&WB Office of Special Counsel: Along with the CIO or CFO, prepares the contract with the service provider selected by the Pension Committee.

S&WB Internal Audit: Assists the BoT by reviewing on a periodic or as-needed basis, compliance with the ERS Professional Services Procurement Policy.

ERS Executive Director: May authorize, with written concurrence of the Special Counsel, emergency procurements for pension/investment-related professional services excluding investment managers which deviate from the procedures detailed herein when there exists a threat to the orderly functioning of the ERS, provided that any emergency procurement must be made with as much competition as is practicable under the circumstances and in compliance with applicable law. A written determination of the basis for the circumstances and for selection of the particular service provider must be included in the contract file. The ERS Executive Director must provide written notice to the BoT within seven (7) calendar days of granting the exception, explaining why the exception was granted.

If any of these positions on the Proposal Selection Committee are vacant, the ERS Executive Director may appoint a professional from within or outside of S&WB with the consent of the Pension Committee. Moreover, if the CIO position is vacant, the ERS Executive Director may retain a firm with specialized expertise in conducting investment consultant searches to advise or assist in analyzing the RFQ/RFP responses. Should the ERS Executive Director engage a non-S&WB-employee individual or firm to advise or assist in the construction, administration, and analysis of the RFQ/RFP, that individual or firm will be required to submit a letter affirming that no conflict of interest exists and full compliance with the disclosure requirements.

PROCUREMENT PROCESS

The procurement process will depend upon the desired type of service. The procurement process differs in that the Pension Committee will receive recommendations from: (a) the Consultant for investment manager candidates and (b) the Proposal Selection Committee for all other pension/investment-related service providers. Regardless of the type of service, all selection decisions (excluding emergencies) will be made by the Pension Committee, contracted by the S&WB Office of Special Counsel, and advertised by the S&WB Purchasing Department, which will also maintain historical files on all contracts.

Sourcing Candidates

Investment Managers

When the need for a third-party investment manager (including transition managers) has been determined, the S&WB Purchasing Department will announce the need in the Official Journal of the City of New Orleans and at least one other appropriate publication (e.g., "Pensions & Investments," "FundFire," "Trusted Insight," etc.). The announcement will state the needed mandate and direct interested parties to the Consultant. The Consultant will advise interested parties what information is required for their database. The Consultant's directions will be posted at all times (i.e., whether a search is being conducted or not) on S&WB's website.

The Consultant will use their investment manager research process to vet investment managers and to propose candidates to the Pension Committee based upon the Consultant's judgment of the best fit in the portfolio and greatest confidence in the investment manager's capabilities to fulfill the given mandate. The Consultant is expected to adhere to its investment manager research process described to the Pension Committee when the Consultant was hired.[1] The Consultant is required to adhere to its standard vetting process and is not required to afford any special consideration outside of its standard vetting process with regard to candidates responding to S&WB Purchasing Department's announcements.

As it would be in investment managers' interest to be included in the Consultant's database as soon as possible, their data requirements shall be posted on S&WB's website as soon as possible after the Consultant is hired. The CIO and trustees will also direct all investment managers he/she meets to the Consultant. Moreover, in advance of any planned major restructuring of the pension portfolio, the CIO and consultant will conduct an advertised public meeting to advise interested investments how to be considered by the Consultant.

The Consultant will discuss with the CIO candidates for consideration by the Pension Committee, but only candidates approved by the Consultant's internal process will be presented to the Pension Committee. The CIO may conduct on-site due diligence on the

[1] When hiring the General Investment Consultant, the RFP should consider the Consultant's research process as it related to Minority Business Enterprises, Women's Business Enterprises, Disadvantaged Business Enterprises, and Small Disadvantaged Businesses.

candidates recommended by the Consultant to verify and better understand the Consultant's recommendation.

Other Service Providers (Non-Investment Managers)

When the need for third-party pension/investment-related professional services excluding investment managers has been determined, the S&WB Purchasing Department will announce the need in the Official Journal of the City of New Orleans and at least one other appropriate publication (e.g., "Pensions & Investments," "FundFire," "Trusted Insight," etc.).

The CIO will begin preparation of either (1) Request for Qualifications ("RFQ") or (2) Request for Proposals. The RFQ/RFP must include, but are not limited to the following:

1. Purpose, Background, and Scope of Project
2. Description of Work to be Performed and Objectives to be Met
3. Deadline for Proposals
4. Identity of Contact Person
5. Timetable for Selection
6. Qualification of Personnel
7. Fees and Costs[2]
8. Relevant ERS Policies
9. Criteria for Evaluation and the Relative Weight Attached to Each

The criterion used and their respective weightings will be established in the RFQs and RFPs by the CIO. The CIO may include criterion such as EDBP certification and location of firm in Orleans Parish (if appropriate), but their weights are limited to 5% to 10% in aggregate of the (100%) total.

Once the RFQ or RFP has been issued, a pre-proposal conference *may* be held for all parties interested in submitting proposals. Potential proposers will receive copies of all questions posed at the conference along with their answers. Any questions not raised at the pre-proposal conference from prospective proposers must be submitted to the S&WB Purchasing Department and answered by the CIO in writing and provided through the S&WB Purchasing Department. All documentation from the pre-proposal conference, along with additional questions posed to ERS will be preserved in the contract folders; originals will be sent to the S&WB Purchasing Department.

[2] Fees and costs shall not be requested on any respondents on RFQ/RFP issued for the selection of providers of design services (La R.S. 38:2318.1).

Once RFQs/RFPs have been issued, the CIO, Proposal Selection Committee, Pension Committee, and other BoT members should not discuss the solicitation with prospective proposers except at Proposal Selection Committee meetings or Pension Committee meetings, respectively. If any of the above are contacted, they should refer the proposer to the appropriate staff member of the S&WB Purchasing Department.
The Proposal Selection Committee will evaluate responses to the RFQ/RFP using the ranking criteria and their respective weightings established in the RFQ/RFP. The Proposal Selection Committee will meet with the S&WB Procurement Director in a recorded public meeting to report their scoring. Responsive parties may be invited for oral interviews before the Proposal Selection Committee.

The CIO will determine whether on-site due diligence would be appropriate. The purpose of the on-site due diligence is to confirm the information provided in the RFQ/RFP of the top two or three highest-ranked candidates. The Proposal Selection Committee will determine whether the CIO ought to conduct due diligence on the top two (2) or the top three candidates (3). The CIO will report his/her findings in writing to the Proposal Selection Committee. Based upon the CIO's written report, the Proposal Selection Committee will decide whether to disqualify a candidate. If a candidate is disqualified, the Proposal Selection Committee will then determine whether a recommendation should be given to the Pension Committee with the remaining candidates, or whether the CIO should conduct due-diligence on the next highest-ranked candidate, or to reissue the RFQ/RFP. The CIO will report the Proposal Selection Committee's decision to the Pension Committee.

If only one RFP response is received, the CIO will determine whether to proceed with a single candidate or reissue the RFQ/RFP. If the CIO decides to proceed with a single candidate, the Proposal Selection Committee will then evaluate the sole RFQ/RFP response to determine whether that the candidate adequately meets the stated requirements. If the Proposal Selection Committee agrees with the decision to proceed, a recommendation will be made to the Pension Committee along with evidence by the S&WB Purchasing Department that a good faith effort was made to obtain proposals from other firms including documentation that public advertisement including notice to interested parties was made. The Pension Committee will then be given the recommendation and response to determine by vote whether to proceed with an interview or reissue the RFQ/RFP. If the Proposal Selection Committee disagrees by a majority vote, the RFQ/RFP will be reissued. If a second attempt to secure additional responses to the RFQ/RFP is unsuccessful, the Pension Committee will decide the appropriate course of action with advice from the CIO.

All Proposal Selection Committee notes ranking the candidate RFQs/RFPs, oral interviews, and CIO on-site due diligence will be filed by the CIO in the project's file.

Selecting Candidates

Generally at least two (2) candidates for any mandate (investment managers or pension/investment-related professional services excluding investment managers) will be presented to the Pension Committee for oral presentations at a regularly scheduled Pension Committee meeting. For each of their respective areas of responsibility, the Consultant or Proposal Selection Committee will determine whether only one (1) or more than two candidates will be presented from which the Pension Committee will select.

The Consultant will also provide reports on each candidate and a recommendation on hiring investment managers. The CIO may also deliver a separate recommendation but only on the investment manager candidates presented by the Consultant.

The CIO will present the Proposal Selection Committee's ranking and on-site due diligence report as well as the finalists' RFQ/RFP responses for pension/investment-related professional services excluding investment managers.
The Pension Committee will select a candidate by vote and resolution and recommend the commencement of contract negotiations. The CIO will execute the S&WB Office of Special Counsel-approved contract and file a copy with the S&WB Purchasing Department.

DISCLOSURE REQUIREMENTS

Each RFQ/RFP shall require the submission by each respondent of a cover letter that includes the following:

- Identify any possible relationships that might impair their ability to perform if awarded the contract, including any familial or business relationships that the firm, the proposed sub-consultants, and their principals have with members of the ERS, S&WB, or any of its employees.
- Respondents are directed to review the Louisiana Code of Ethics (Louisiana Revised Statutes Title 42:1101-1125) as a non-exclusive reference for information regarding ethics and conflicts of interest.
- Affirmation that there is not a conflict of interest.
- Although the use of subcontractors is rare in the mandates used by ERS, respondents shall also be required to identify all proposed subcontracts to be utilized in connection with the project. The successful respondent shall notify the Board of any change in subcontractors and obtain prior approval of the use of any new subcontractors before they can begin work on the project.

Each member of the Proposal Selection Committee shall submit a signed statement prior to review of the proposals and the ERS Executive Director shall include a signed statement prior to any emergency procurement that deviates from this Procurement Policy (as described above) that includes the following:

> "I hereby certify that I have no personal interest, economic or otherwise, in the proposed contract with the ERS for which I am evaluating bids on the RFQ and/or RFP as member of the Proposal Selection Committee. Further, I certify that I have no relationship with any of the proposers or bidders, be it economic or otherwise that would affect my ability to be fair and impartial in the review/selection process."

Members of the Pension Committee will be read the above statement and asked verbally whether they need to recuse themselves from a decision.

The Consultant will annually provide a disclosure on conflicts of interest.

INSTITUTIONAL FIDUCIARY SOLUTIONS

Objective Guidance for Institutional Investors

Sewerage and Water Board of New Orleans
Employees' Retirement System

FFC INVESTMENT ADVISORS of RAYMOND JAMES®

Octave J. Francis III, CIMA®
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UNIQUE CHALLENGES REQUIRE UNIQUE SUPPORT

Our Mission

At Raymond James, we understand the importance of our clients meeting their investment stewardship obligations. We take an objective, unbiased approach and tailor our guidance and services to each client situation.

The team of investment professionals at Raymond James Institutional Fiduciary Solutions works with us to provide for all aspects of investment consulting – from strategy development and investment research to reporting and periodic reviews. Our proactive advice includes the creation and implementation of a well-defined process for making informed investment decisions based on prudent investment practices. Each investment strategy is developed in consideration of well-established fiduciary standards and is backed by our philosophy of conservative management.

There is no assurance that any investment strategy will be successful. All investing involves risk and you may incur a profit or loss.

THE RAYMOND JAMES ADVANTAGE:
GLOBAL RESOURCES, LOCAL ACCOUNTABILITY.

FFC Investment Advisors of Raymond James
Octave J. Francis III, CIMA®
Managing Director
Senior Vice President, Investments

Institutional Fiduciary Solutions

Thomas Thornton*, CFA
VP, Research, AMS

Nicholas Lacy*, CFA
Chief Portfolio Strategist, AMS

Christopher Butler, CFA, CAIA
SVP, PCG Investment Products

INSTITUTIONAL CONSULTING

Bob Burns
CFA, AIF

Dwight Edwards
CRPS, CRPC

Dickson Logan
AIF, CPFA

Susan Schneider
CIMA, CIMC, AIF

Kevin Kozak
AIF

Andrew Keil
AIF

1 CFA **1 CRPS**
1 CIMA **1 CRPC**
1 CIMC **1 CPFA**
5 AIF

CONSULTING SUPPORT

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Director, AIF

Kevin Kuzianik
CRPS, CPFA

Shelly Hardison
CRPS, CPFA

Richard Placey
CRPS

Todd Fullam
CPFA

David Marsh

Joel Rodriguez

Annemarie Burgess

3 CRPS **3 CPFA**
1 AIF

MANAGER DUE DILIGENCE

Glenn Hudson

Lawrence Gillum
CFA, CAIA

Andrew Read*
CFA

Johnny Suarez

Jeffrey Gardner
CFA

Patrick Rassi
CAIA

Andrew Gillis
CAIA

Andrew Flinner

William Warner
CFA

Donovan Celerin

Tyler Martinasek

Xianwei Cheng

James Dowdle

Leon Faust

Lisa Marshall

Truc Bui

Alex Bolton

Carlos Panatex

5 CFA **3 CAIA**

ASSET ALLOCATION

Kevin Pate*
CAIA

Michael Meleen

Jeremy Brothers
CFA

Sandrina Riddell
CFA

Eric McNew

Mark Arkelian
CFA

Dusica Tomasevic

Dan Schutz

2 CFA **1 CAIA**

ALTERNATIVE INVESTMENTS

Ryan Stolz
CFA, CAIA

Shivam Patel

Charlie Kusche
CAIA

Carla Johnson

Felipe Manzo

James Hale

Allison Tucker
CAIA

Nicholas Asselin

Maria Garcia

3 CFA **5 CAIA**

Raymond James information as of 2/8/18. *Asset Management Services Investment Committee member (AMS IC): The AMS Investment Committee is composed of experienced personnel within AMS Management and Research. The Committee collectively determines the asset allocations for Freedom and Freedom UMA strategies, as well as making hiring and firing decisions for AMS managers.

RAYMOND JAMES®

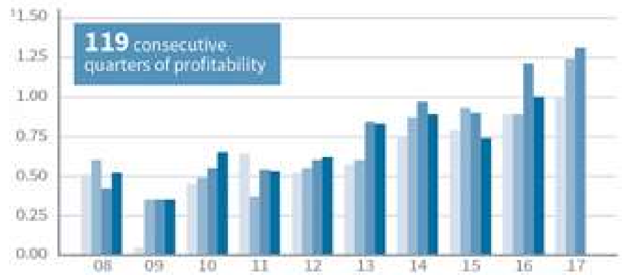
PROVEN HISTORY. PROVEN EXPERIENCE.

Raymond James has delivered **119 consecutive quarters of profitability**. We credit much of this performance to the firm's client-first perspective and adherence to its founding core values of **professional integrity, advisor independence, and a conservative, long-term approach to investing**.

BY THE NUMBERS

- Approximately 7,300 financial advisors
- Over 3,000 locations (United States, Canada and abroad)
- Approximately $693 billion in total client assets
- More than 2x required total capital ratio
- BBB+, positive outlook credit rating (S&P)

STRENGTH AND STABILITY – Diluted quarterly earnings per share



DID YOU KNOW?

In 2017, Raymond James was named to the FORTUNE 500 list for the second year in a row.

Continuing its tradition of giving back, Raymond James and its associates donated **$46.37 million** to charitable organizations in 2016, including **$5.19 million** to the United Way and its partner agencies.

Raymond James was the first in the nation to publish its Client Bill of Rights, setting the standard for the industry.

A DIVERSIFIED SET OF BUSINESSES*

Total $6.4 billion

Total net revenue shows fiscal year data ending Sept. 30, 2017

As of 9/30/2017. Past performance is not an indication of future results. The information provided is for informational purposes only and is not a solicitation to buy or sell Raymond James Financial stock. The FORTUNE 500 is an annual list by FORTUNE magazine that ranks 500 of the largest U.S. corporations based on fiscal-year total revenues. FORTUNE and FORTUNE 500 are registered trademarks of Time Inc. and are used under license. From FORTUNE Magazine, June 15, 2016. ©2016 Time Inc. Used under license. FORTUNE and Time Inc. are not affiliated with and do not endorse products and services of Raymond James Financial, Inc. Raymond James Bank is an affiliate of Raymond James & Associates, Inc., and Raymond James Financial Services, Inc. Investment products are: not deposits, not FDIC/NCUA insured, not insured by any government agency, not bank guaranteed, subject to risk and may lose value. 17-BDMKT-2845 10/17

RAYMOND JAMES®

OBJECTIVE ADVICE FOR INSTITUTIONAL INVESTORS

Who do we serve?

- Nonprofits
- Insurance Pools
- Foundations & Endowments
- Corporations
- Native American Entities
- Pension Plans
- Taft Hartley Plans
- Governments & Municipalities

A FULL BREADTH OF SERVICES. SOPHISTICATED INVESTMENT TOOLS AND STRATEGIES.

- Investment Policy Review and Development Assistance
- Asset Allocation Analysis and Guidance
- Investment Search and Selection Assistance
- Performance Reporting
- Research and Due Diligence
- Services and Education for Fiduciaries

Disclosure: All investing involves risk and you may incur a profit or a loss. There is no guarantee that this or any investment strategy will be successful. Diversification does not ensure a profit or protect against a loss.

GLOBAL FIDUCIARY PRECEPTS®

We understand the importance of our clients meeting their stewardship obligations. As a foundation of our process, Raymond James Institutional Fiduciary Solutions develops guidance and provides other services to help us align client processes with the Global Fiduciary Precepts®[1] ensuring every decision is approached with discipline, transparency and control.

The Center for Fiduciary Studies Global Fiduciary Precepts®:

1. Know standards, laws and/or trust provisions.
2. Diversify assets to the specific risk/return of client.
3. Prepare an investment policy statement.
4. Use prudent experts (professional money managers) and document due diligence.
5. Control and account for investment expenses.
6. Monitor the activities of prudent experts.
7. Avoid conflicts of interest and prohibited transactions.

Disclosure: Diversification does not ensure a profit or protect against a loss.

OUR APPROACH

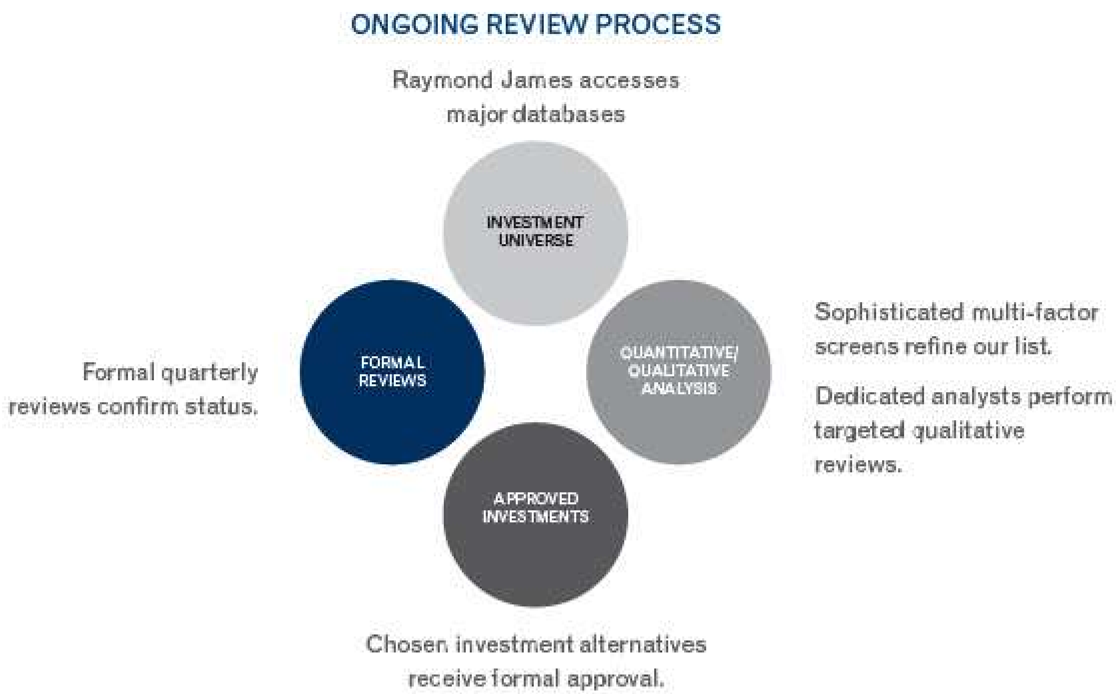
In line with Raymond James Institutional Fiduciary Solutions' mission statement, we have developed a clearly defined four-step process designed to provide additional discipline and structure to the consulting services we deliver to each client.

There is no assurance that any investment strategy will be successful. All investing involves risk.

MONITORING AND COMMUNICATION

We work with the professionals of Institutional Fiduciary Solutions during all stages of the relationship.

Once the investment process is established and investments are implemented, our work and communications continue. Each investment solution we help our clients select within the Raymond James Consulting Services and Freedom programs receives our ongoing analysis and review, as detailed in the graphic to the right. In some cases we may also assist you in the development of an alternate monitoring process for other investments within your portfolio.



Disclosure: All investing involves risk and you may incur a profit or a loss. There is no guarantee that any investment strategy will be successful.

MONITORING AND COMMUNICATION

Made up of a team of highly qualified investment professionals from AMS Institutional Research and Due Diligence, the AMS Research team develops optimal, risk-adjusted asset allocations and strives to include top investment managers into the Raymond James Institutional Portfolios, Freedom portfolios and Raymond James Consulting Services program.

The AMS Research team performs the following analyses on an ongoing basis on each portfolio it selects:

- Monitors the firm, personnel and portfolio
- Manager contact
- Onsite visits
- Meetings at the home office
- Conference calls
- Systems include Callan, MorningStar, FactSet and Informa PSN
- Develops relationships with managers
- Quarterly quantitative and qualitative reviews
- Issues status updates

AMS RESEARCH STATISTICS (Annually)	
Onsite Visits	100+
Home Office Visits	250+
Conference Calls	150+
Traveled Days	100+
Traveled Miles	50,000+

EXTENSIVE EXPERIENCE

- A combined 300 years of industry experience
- Average of 17 years of industry experience per person[1]
- Twelve advanced degrees
- Nine Chartered Financial Analyst (CFA) charterholders
- Five Chartered Alternative Investment Analyst (CAIA) charterholders

As of 9/30/2017
[1]For senior analysts and above

Disclosure: All investing involves risk and you may incur a profit or a loss. There is no guarantee that this or any investment strategy will be successful. Diversification does not ensure a profit or protect against a loss.

RAYMOND JAMES®

UNIQUE MONITORING TOOL:
CLIENT SERVICE PLAN

We offer a customized *Client Service Plan,* which is a unique monitoring tool that serves to summarize performance report information relative to a defined monitoring criteria. This tool also serves to document a client's stewardship and enables more effective and efficient decision making.

RAYMOND JAMES®

INSTITUTIONAL FIDUCIARY SOLUTIONS: ADDITIONAL RESOURCES

We take an objective, unbiased approach and tailor our guidance and services to each client situation. We can provide customized solutions based on the needs of our clients. These solutions may include:

- Quarterly economic analysis and commentary
- Annual review of overall investment strategy
- Spending policy review and analysis
- Socially Responsible Investing
- Implementation of Liability Driven Investment (LDI) mandates
- Review and evaluation of past investment performance and asset allocation
- Comprehensive Performance Reporting with multiple custodians and/or advisors

Disclosure: All investing involves risk and you may incur a profit or a loss. There is no guarantee that any investment strategy will be successful.

OUR INSTITUTIONAL DIFFERENCE

Raymond James provides a broad array of comprehensive resources and the exclusive dedication that is required in servicing some leading companies, financial institutions and foundations. Our commitment and dedication are made evident by:

- Disciplined approach to investment management
- Independent due diligence process and research
- Ongoing monitoring and attribution analysis
- Access to world-class managers
- Ability to deliver customized performance reporting
- Dedicated, full-time team of professionals

All investing involves risk and you may incur a profit or loss. There is no assurance that any investment strategy will be successful.

DISCLOSURE

Further information on the funds selected for the Raymond James Institutional Portfolios and Freedom portfolios is available by prospectus, which can be obtained through your financial advisor. Investors should carefully consider the investment objectives, risks, charges and expenses of mutual funds and exchange-traded funds before investing. All investments are subject to risk. The prospectus contains this and other information about the funds and should be read carefully before investing.

The foregoing content reflects the opinions of Raymond James Asset Management Services and is subject to change at any time without notice. Content provided herein is for informational purposes only and should not be used or construed as investment advice or a recommendation regarding the purchase or sale of any security outside of a managed account. This should not be considered forward looking, and are not guarantees of future performance of any investment.

All investing involves risk. Asset allocation and diversification does not ensure a profit or protect against a loss. All investments are subject to risk. There is no assurance that any investment strategy will be successful. It is important to review the investment objectives, risk tolerance, tax objectives and liquidity needs before choosing an investment style or manager. All investments carry a certain degree of risk and no one particular investment style or manager is suitable for all types of investors.

VIEZER, Timothy

From: Aon Retirement and Investment Blog <do_not_reply@aon.com>
Sent: Thursday, April 26, 2018 8:23 AM
To: VIEZER, Timothy
Subject: [New post] Firearms and Munitions Exposure in Your Portfolio Copied

AON

In the wake of the Parkland, Florida school shooting at Marjorie Stoneman Douglas High School in February, 2018, there has been increased interest from investors in divestment from holdings related to guns and weapons. Aon has put together the following thoughts on this topic.

Aon's Policy on Divestment

Generally speaking, Aon suggests that investors eschew divestment in lieu of active engagement policies. We believe that investors that sell positions lose what is perhaps their only significant bargaining chip with a company – their proxy vote. As active investors, shareholders can suggest resolutions and band together for proxy votes that stand a chance of influencing future company behavior. Investors may engage with companies directly to the extent they own stock outright, as New York Common has elected to do in an attempt to increase board diversity[i], or investors can request that outside asset managers interact with corporate management to effect change. One recent example of such a campaign occurred in October 2017, when a group of shareholders, led by Zevin Asset Management, began a campaign to encourage Starbucks to improve its paid family leave policy.[ii]

Unfortunately, once an investor is no longer a shareholder in a company, their opportunity to engage with that company and influence corporate behavior is diminished, and may in fact be limited to protests, letter-writing campaigns and other forms of indirect impact. Certainly, as Bill O'Reilly and, more recently Laura Ingraham discovered, public pressure can force companies (in this case Fox News) to change their behaviors. However, generally speaking, research has shown that consumer driven boycotts often do not result in negative financial consequences for a targeted firm.[iii]

In addition, divestment results in tracking error, with the associated risk of underperformance relative to an undivested benchmark, and also reduces portfolio diversification. The study "The Divestment Penalty: Estimating the Costs of Fossil Fuel Divestment to Select University Endowments" (Bradford Cornell, 2015) examines the potential fossil fuel divestment cost to Harvard, Yale, MIT, Colombia and NYU, projecting that, if a set of major institutions that pursued divestment continued to do so, and experienced return shortfalls in line with what they experienced in the past, their weighted average asset shortfall would be 6.4% over 20 years and 16.7% over 50 years.[iv] In addition, research in the wake of CalPERS $671 million tobacco divestment in 2000 found that the total amount of their foregone gains during the period stood at $3.6 billion.[v] Actual return experience from divestment will be highly dependent on the specifics of the divestment strategy and the actual, unpredictable, long term returns of the divested securities. In 2015, a meta-study that examined 75 primary studies found that there was no significant impact on performance as a result of negative screening – either positive or negative.[vi] Given the uncertainty around the issue, including risk of reduced diversification increased tracking error and risk of underperformance relative to a market benchmark, Aon continues to urge caution around divestment, particularly if there is a possibility of corporate engagement.

We do recognize that some organizations, either because of strongly held beliefs, public pressure, state laws, specific missions or a combination thereof may have reason to divest from certain investments, especially if the only desired corporate behavior is that they stop engaging in essential businesses. In these instances, divestment may be appropriate and Aon stands ready to work with these investors, after apprising them of applicable risks and rewards.

Firearms Divestment: Practical Guidelines and Implications

Aon's research has found roughly 16 publicly-traded securities focused on firearms and munitions, including eight listed on the NYSE, three that trade over the counter and five that are listed on foreign exchanges. There are additional companies involved in the manufacturing and sale of firearms and munitions, but the remaining firms, including those that may be household names, are generally privately held. Both publicly traded and privately traded firearms stocks may be included in a variety of indexes and investment manager portfolios.

The relatively small number of publicly traded firearms stocks often surprises investors, as does the comparatively modest economic impact of the firearms industry on the U.S. economy. The following chart shows the impact of the firearms industry on the US economy, including business revenues, business profits, personal wages and jobs. While $51 billion may seem like a large number, the economic impact of the coffee industry, for example, tops $225.2 billion[vii], and firearms opponents highlight that the cost of fatal and non-fatal gun violence in the US was $229 billion, which includes $8.6 billion in direct expenses for emergency services and medical care.[viii]

Economic Impact of the Sporting Arms and Ammunition Industry in the United States

	Direct	Supplier	Induced	Total
Jobs (FTE)	141,500	66,614	93,009	**301,123**
Wages	$5,847,837,400	$4,522,015,700	$4,813,571,600	**$15,183,424,700**
Economic Impact	$20,223,132,100	$15,525,775,600	$15,502,536,200	**$51,251,443,900**

[ix]

Source: John Dunham & Associates, New York, December 2016

For Aon clients that manage direct investments, the path to divestment is relatively straightforward: Investors would need to identify their exposure to firearms stocks, evaluate the cost of divestment, and then determine whether or not to exit those positions.

However, many of Aon's investor clients and prospects manage insignificant amounts or even no assets in-house, so divesting directly may not be an option or may only address some of their firearms exposure. For example, when CalPERS divested of directly-managed tobacco stocks, they made no requirement that underlying managers do the same. As a result, in early December 2016, CalPERS still had 0.2% of their portfolio exposed to tobacco-related investments, despite their earlier direct divestment initiative.[i] CalPERS voted to require underlying investment managers to also divest from tobacco later that month.[ii]
Because of their reliance on outside money managers, Aon's institutional clients will almost certainly need to consider engaging with external investment managers in their portfolios if they wish to pursue divestment. Possible courses of action include:

- Examine index funds for exposure to firearms and determine a suitable course of action, which may involve either a determination to either maintain exposure to those indices or to initiate a search for firearms-free index options.
- Discuss firearms exposure and divestment options with separate account and other investment managers to determine whether divestment is feasible or desirable from the manager's point of view.
- Be aware that there may be transaction costs associated with selling targeted stocks and/or maintaining a firearms free account. A number of separate account managers to whom we've spoken have expressed a willingness to manage a simple negative screen without significant additional fees from the investor, but any costs associated with divestment will need to be evaluated on a case-by-case basis.
- Examine firearms-free separate accounts and funds if existing fund managers are unwilling or unable to accommodate firearms divestment requirements.
- Engage with private equity and other fund managers who own or have exposure to privately-held firearms firms and determine if divestment from those underlying firms is possible.
- Investors should understand that some investment managers may be unable or unwilling to accommodate specialized divestment mandates within commingled products, so an exact replica of an existing portfolio may not be feasible.

In addition, investors who opt to divest from firearms will also need to determine whether they wish to divest of general and sporting goods retailers that sell firearms and providers of tangential services (such as training and safety equipment) as well. It is important to note that, as the net is cast wider to include major retailers and other companies with services related to guns, investors will likely increase their risk of tracking error.

Conclusion

There are a number of reasons why an investor might choose to consider divesting from firearms and munitions firms, particularly as national debate on the topic intensifies. There are a number of nuances involved with any divestment, however, and as fiduciaries, investors will need to fully vet the cost, benefit and feasibility of such a move before proceeding.

Meredith Jones is a Partner in Aon's Global Investment Management group and is based in Nashville, TN.

"Content prepared for U.S. subscribers, but available to interested subscribers of other regions."

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[i] http://www.latimes.com/business/hiltzik/la-fi-hiltzik-tobacco-calpers-20161214-story.html
[ii] https://www.calpers.ca.gov/page/newsroom/calpers-news/2016/votes-expand-tobacco-investment-ban

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[i] https://www.seattletimes.com/business/ny-state-pension-fund-pushes-for-corporate-board-diversity/
[ii] https://www.theguardian.com/business/2017/oct/02/starbucks-investors-coffee-family-parental-birth-leave
[iii] https://psmag.com/economics/how-to-use-boycotts-for-social-good
[iv] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2655603
[v] http://www.latimes.com/business/hiltzik/la-fi-hiltzik-tobacco-calpers-20161214-story.html
[vi] https://www.cnbc.com/2017/06/16/how-to-win-in-socially-responsible-investing-dont-exclude-bad-stocks.html
[vii] http://www.ncausa.org/Industry-Resources/Economic-Impact
[viii] https://www.cbsnews.com/news/las-vegas-shooting-gun-violence-economic-costs/

Callan

CALLAN INSTITUTE

Survey

2017 ESG Survey

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Executive Summary

Introduction

In August 2017, Callan conducted our fifth annual ESG survey. The results reflect input from 105 unique institutional U.S. funds with more than $1.1 trillion in assets.

Over the last five years, these surveys reveal that U.S.-based institutional investors have increasingly incorporated environmental, social, and governance (ESG) considerations into their investment decision-making process. After several years of education around ESG issues, in 2017 overall incorporation rates held steady with the previous year at more than one-third of total funds.

ESG factor incorporation levels off after years of steady growth

Overall incorporation of ESG factors into investment decision-making plateaued at 37% of respondents in 2017, on par with 2016 (37%) and up from 2013 (22%). This trend reflects changing survey respondents over time (a larger portion of smaller and corporate funds responded in 2017 than in previous years), as well as multiple years of investor education around ESG coming to fruition. Further suggesting a plateau in adoption rates, 7% of respondent firms that have not yet incorporated ESG factors into investment decisions were considering doing so in the future, down from 22% in 2016.

By fund type, we note a slight dip in the rate of ESG incorporation among corporate and endowment funds compared to 2016 (likely due to sample changes over time) while other fund types saw a continued rise in adoption:

- 35% of public funds indicated they incorporate ESG factors into the investment decision-making process, up from 25% in 2016
- Foundations reported the highest rate of ESG incorporation at 56% in 2017 (vs. 48% in 2016)

The largest of funds (with $20 billion in AUM or more) continued to incorporate ESG factors into the investment decision-making process at a much higher rate than their smaller counterparts: 78% for the largest funds compared to 30% for the smallest funds ($500 million in assets or less).

Key Findings

Callan's fifth annual *2017 ESG Survey* reflects trends on ESG adoption for U.S. institutional funds. The results reflect input from 105 unique institutional U.S. funds and trusts with more than $1.1 trillion in assets.

7%

of those who have not yet incorporated ESG factors are considering it

50%

of those who have incorporated ESG added language to the investment policy statement

78%

of largest funds have incorporated ESG factors into investment decisions

Most frequently cited reason to incorporate ESG:

My fund must consider ESG factors as part of our fiduciary responsibility

68%

Increase in the rate of ESG adoption since inception of survey in 2013

ESG incorporation by region

Pacific	53%
Northeast	44%
Central	32%
Southeast	21%
Mountain	20%

88%

of corporate funds surveyed incorporated ESG factors in order to complete their fiduciary duty

56% foundations

39% endowments

35% public funds

25% corporate

41%

of respondents define ESG using the literal definition, implying an acceptance of the definition provided by managers hired

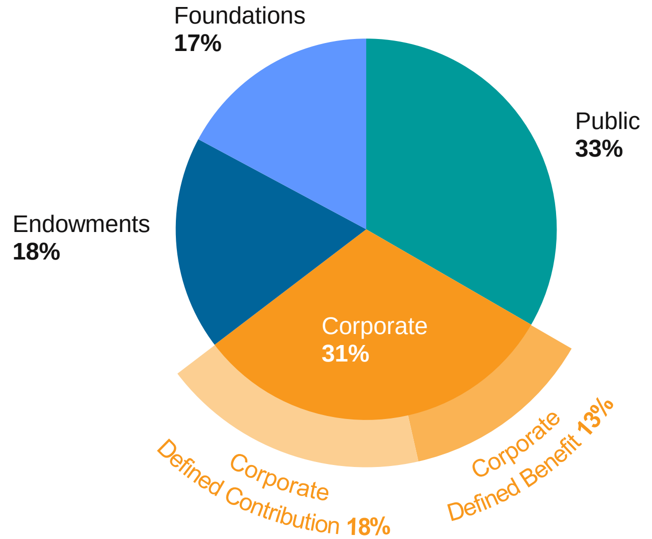
Respondent Overview

105 funds and trusts responded to the survey; approximately one-third public funds, one-third corporate funds, and one-third endowments & foundations

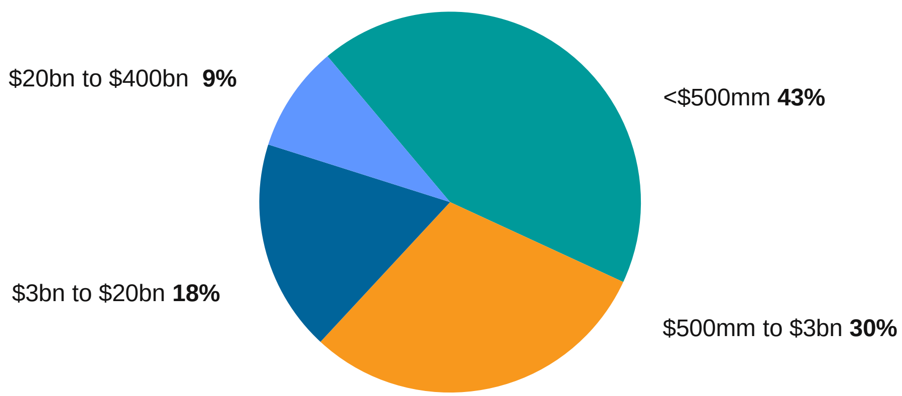
>$1.1 trillion in total assets are represented in this survey

43% of respondents are "small" funds with $500 mm or less in assets; smaller funds are less likely than their larger counterparts to adopt ESG practices

Respondents by Fund Type



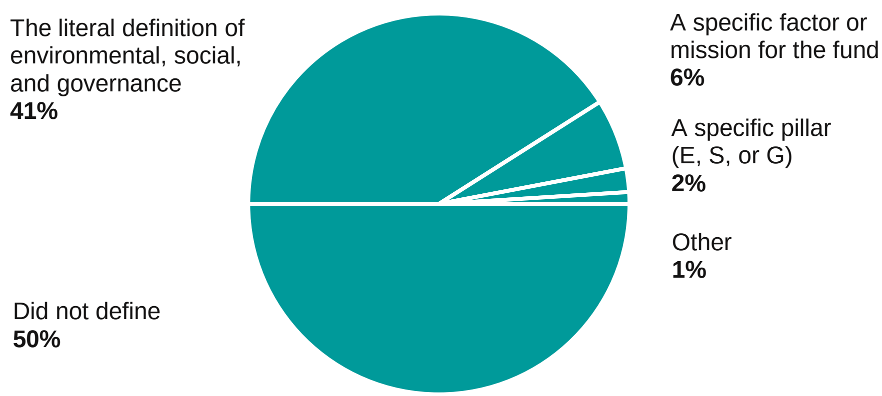
Respondents by Fund Size



Defining ESG

How Funds Define ESG

Callan has found that definitions of ESG vary widely in the industry. Logically, defining ESG is often the first step many funds take in exploring implementation.



50%

of respondent firms did not define or attempt to define ESG in 2017, up from 33% in 2016.

41%

defined ESG using the literal definition of environment, social, and governance considerations, up from 35% in 2016.

Fewer funds (8%) defined ESG by a specific pillar, factor, or mission than a year ago (17%), suggesting broadening definitions of ESG beyond individual issues that can be targeted for divestment.

ESG Factor Adoption Rates

Callan asked whether or not respondent funds have "incorporated ESG factors into investment decision-making." This language is intentionally broad in order to capture as many potential implementations as possible that reflect the prevalence of ESG considerations in the institutional investment arena.

Overall: The percentage of respondents in 2017 that had incorporated ESG factors into decision-making leveled off at 37%, on par with 2016 (37%). This trend reflects changing survey respondents over time (a larger portion of smaller and corporate funds responded in 2017 than previous years), as well as multiple years of investor education around ESG coming to fruition.

By Fund Type: Foundations and endowments have been the greatest adopters of ESG compared to other fund types over the last five years and in 2017 at 56% and 39%, respectively. Corporate funds saw a decrease in ESG adoption year over year, from 30% in 2016 to 25% in 2017, but an overall increase from 15% five years ago. Corporate defined benefit plans saw a modest dip in adoption from 29% in 2016 to 25% in 2017. This was after a leap from 7% in 2015, which Callan partially attributes to the Department of Labor's 2015 bulletin clarifying that investment strategies that consider ESG factors can be in compliance with their fiduciary duty under ERISA. More than one-third of public funds reported incorporating ESG (35%) in the 2017 survey, up from 25% in 2016.

By Fund Size: The majority (78%) of the largest respondents ($20 bn or greater) have incorporated ESG factors into investment decisions. The largest funds have incorporated ESG factors at the highest rate since the inception of the survey in 2013, while smaller funds are less likely to make ESG considerations part of the investment process.

By Region: 2017 survey respondents were from across the U.S.: 36% Central, 26% Northeast, 18% Southeast, 15% Pacific, and 5% Mountain. The Pacific region had the highest percentage of funds incorporating ESG factors at 53%, followed by the Northeast (44%) and Central (32%).

Looking Forward: Only 7% of respondents that have not yet incorporated ESG into investment decision-making are considering doing so. This is less than one-third of the amount considering this decision in 2016 (22%), suggesting many of the firms that have expressed interest in ESG are on the path to implementation or have decided not to implement.

ESG Factor Adoption Rates Overall

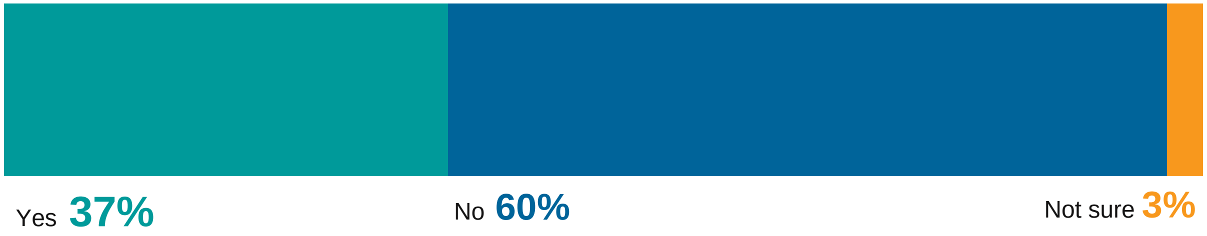
37%

of respondents had incorporated ESG factors into investment decisions in 2017, on par with 2016. The 2017 survey reflects a greater portion of responses from smaller funds (<$500 mm) and corporate funds, which are less likely than larger funds and other fund types to incorporate ESG into the investment process.

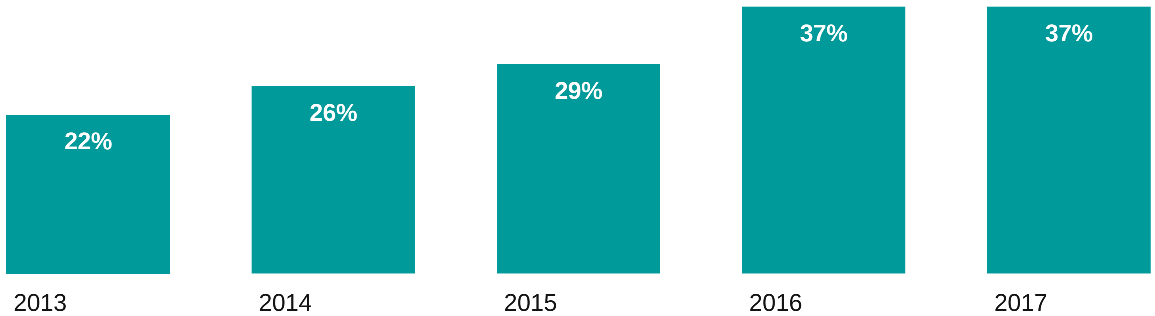
68%

increase in respondents that have incorporated ESG factors into investment decisions from 2013 to 2017.

2017: Does your fund incorporate ESG factors into investment decisions?



Funds that have incorporated ESG factors into investment decisions over time

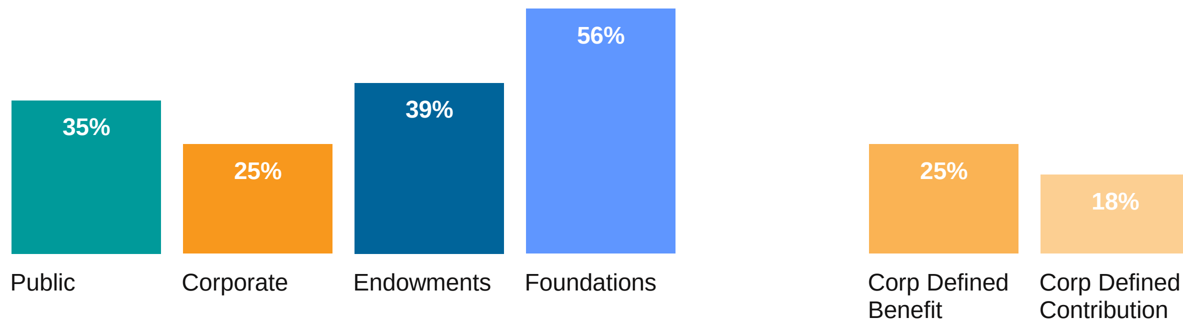


ESG Factor Adoption Rates by Fund Type

56%

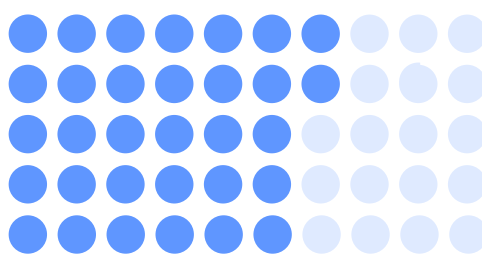
of foundations have incorporated ESG factors into investment decisions, the 2017 survey found. Foundations have incorporated ESG factors at a higher rate than all other fund types in 4 out of the 5 years that Callan has fielded this survey.

2017 funds that are incorporating ESG factors into investment decisions



By fund type over last five years

2013	2014	2015	2016	2017
Foundations **31%**	Foundations **35%**	Foundations **39%**	Endowments **53%**	Foundations **56%**
Endowments **22%**	Endowments **34%**	Endowments **37%**	Foundations **48%**	Endowments **39%**
Corporate **22%**	Public **22%**	Public **27%**	Corporate **30%**	Public **35%**
Public **15%**	Corporate **15%**	Corporate **15%**	Public **25%**	Corporate **25%**



64%

of foundations have incorporated ESG factors into investment decisions in 2017 or are considering doing so in the future.

ESG Factor Adoption Rates by Fund Size

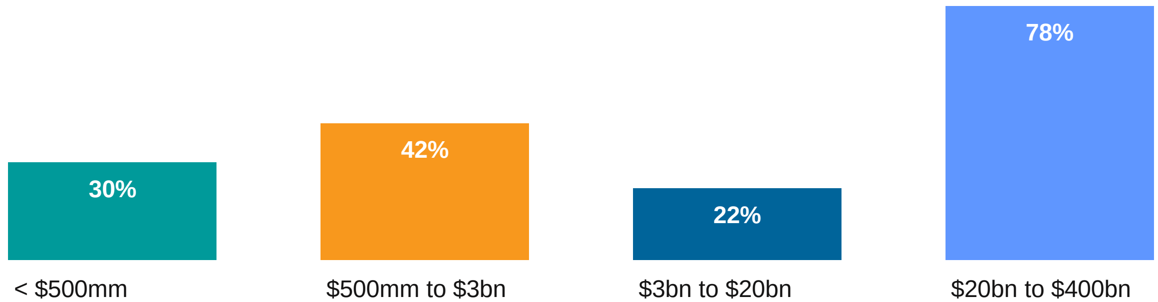
78%

of the largest respondents (>$20 bn) have incorporated ESG factors into investment decisions. The largest funds have incorporated ESG factors at the highest rate since the inception of the survey.

136%

Increase in respondents >$20bn that have incorporated ESG factors into investment decisions from 2013 to 2017.

2017 funds that are incorporating ESG factors into investment decisions



By fund size over last five years

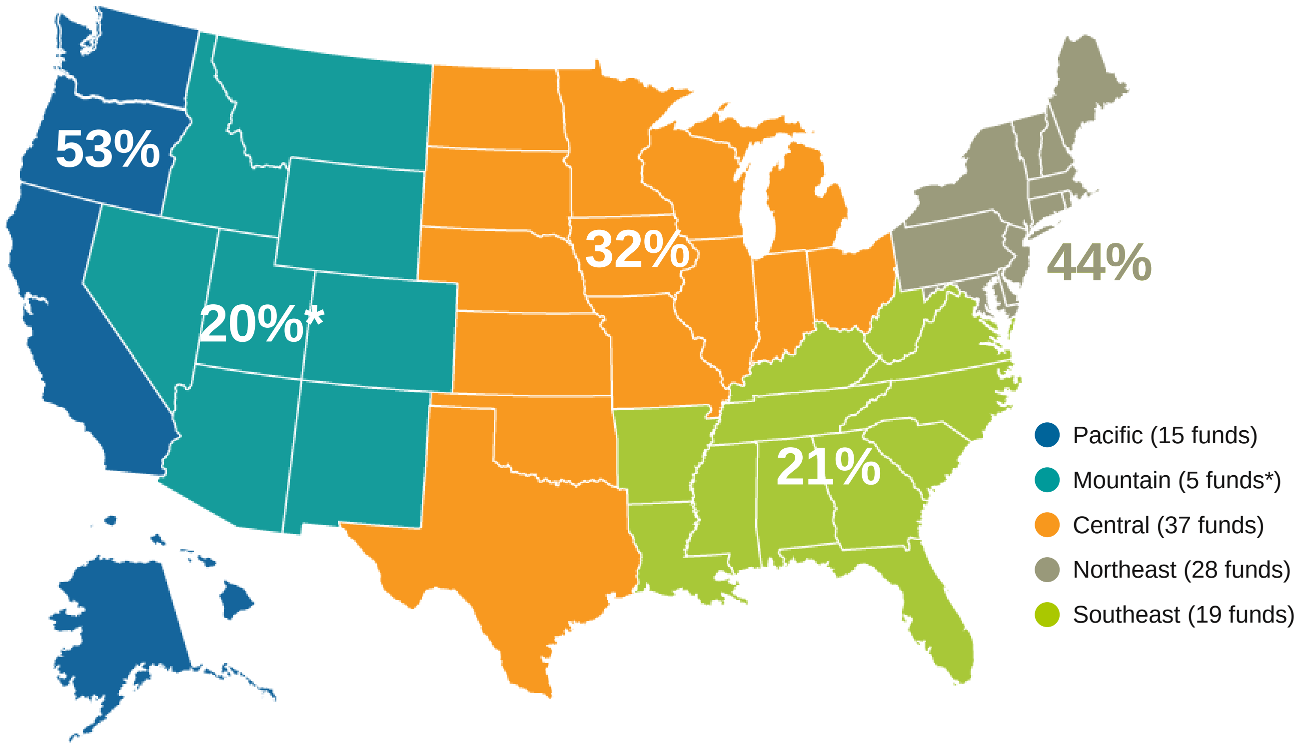
2013	2014	2015	2016	2017
$20bn to $400bn **33%**	$20bn to $400bn **31%**	$20bn to $400bn **35%**	$20bn to $400bn **71%**	$20bn to $400bn **78%**
$3bn to $20bn **29%**	$500mm to $3bn **24%**	$3bn to $20bn **31%**	<$500mm **39%**	$500mm to $3bn **42%**
$500mm to $3bn **23%**	<$500mm **22%**	<$500mm **26%**	$3bn to $20bn **33%**	<$500mm **30%**
<$500mm **20%**	$3bn to $20bn **18%**	$500mm to $3bn **26%**	$500mm to $3bn **29%**	$3bn to $20bn **22%**

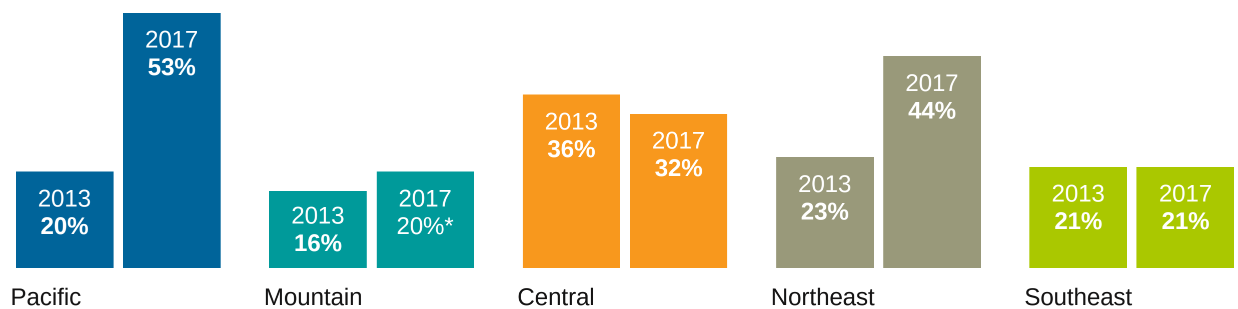
ESG Factor Adoption Rates by Region

165%

increase in rate of Pacific region respondents that have incorporated ESG factors into investment decisions over a five-year period.

2017 funds that are incorporating ESG factors in investment decisions by region





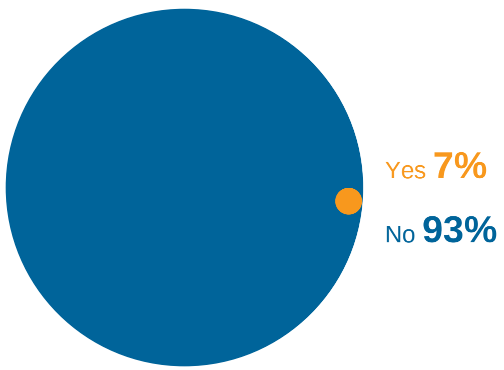
*Note the small sample size.

ESG Factor Adoption Rates Looking Forward

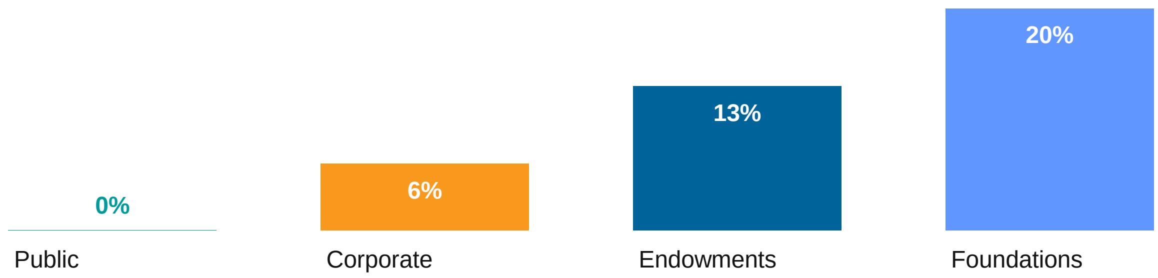
70%

decrease in the percentage of respondents that are considering incorporating ESG factors into investment decisions.

If you have not incorporated ESG factors into investment decisions, are you considering it?



Share of respondents that have not incorporated ESG factors into investment decisions but are considering it (by fund type)



ESG Implementation

Similar to ESG definitions, implementation strategies vary substantially from fund to fund, as investors find the approach that best accomplishes their unique goals. Callan asked survey respondents that have incorporated ESG factors into investment decisions specifically how they had done so to gauge which implementation strategies are most prevalent.

The top implementation method for survey respondents that are incorporating ESG into investment decisions in 2017 was to add language to the investment policy statement (50%), which was also the most common implementation method in 2016 (53%). Callan finds that adding language to investment beliefs or policy statements is frequently a first step that many institutional investors take when pursuing an integrated approach to incorporating ESG factors in investment decisions.

The next most prevalent implementations were:

- to communicate to their investment managers that ESG is important to the fund,
- to hire a manager that has incorporated ESG, and
- to incorporate a screening process and to communicate to investment managers that ESG is important to the fund (42% each).

A negative screening process can address a specific issue (e.g., screen out investments related to tobacco or fossil fuels), but positive screening is also becoming more prevalent (e.g., screen to include only securities that have best practices in a specific sector). Engagement/proxy voting ranked fifth, with 32% of investors utilizing this method. One-fifth of respondents (21%) indicate they are a Principles for Responsible Investment (PRI) signatory, double the rate in 2016 (10%).

ESG Implementation

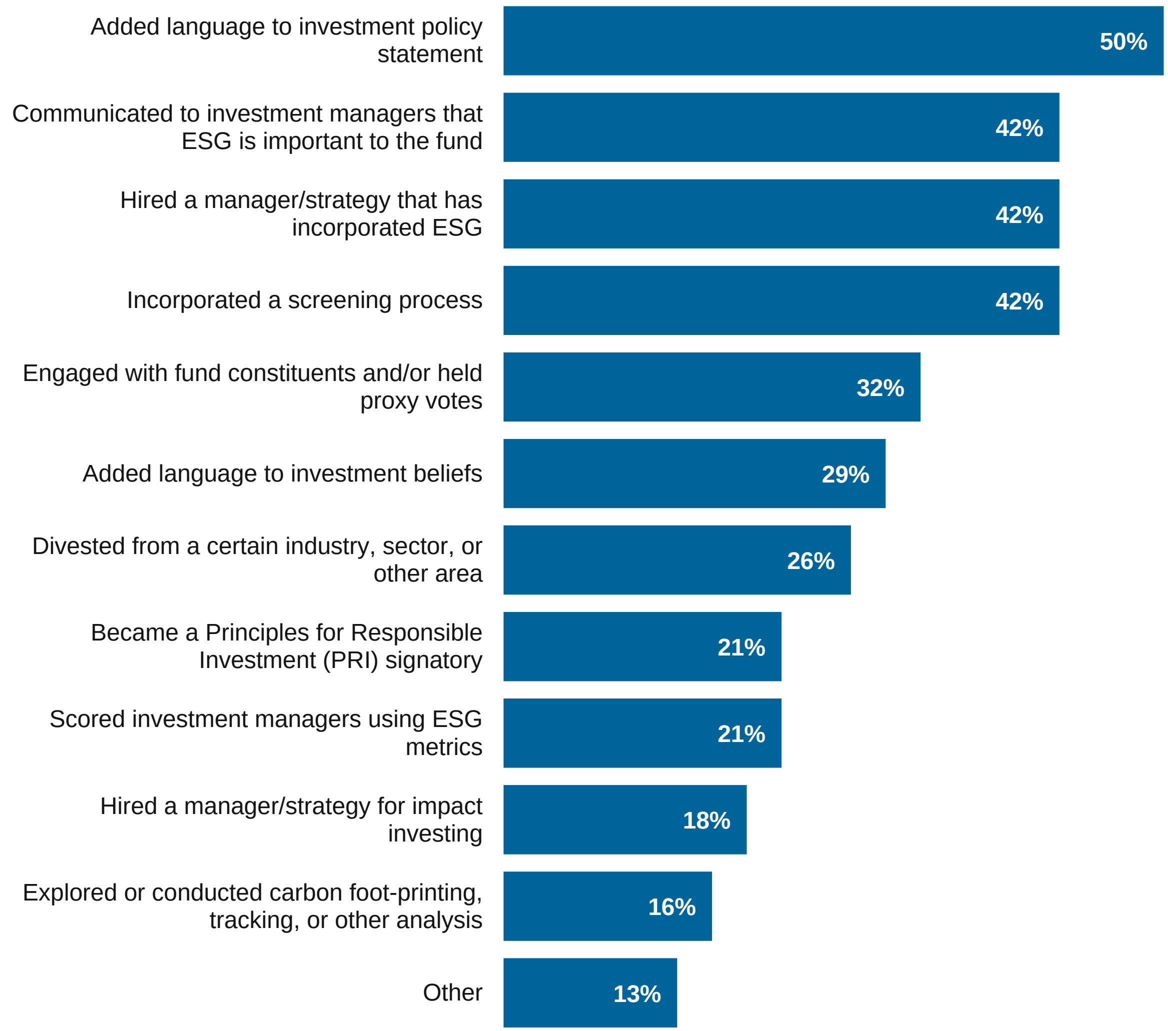
“Other” responses include:

“Divested [out] of industries with negative environmental records”

“Adopted a five-year strategic plan for ESG which includes KPIs, milestones, with targets included in senior staff performance targets”

“Use [consultant] on an ad hoc basis for ESG analysis of managers”

Implementation methods for incorporating ESG factors into the investment decision-making process



Reasons For and Against ESG

Reasons to Use ESG Factors

On the following page we show the motivations for incorporating ESG into investment decision-making. The order of these factors has changed little over the past two years; the top reasons cited for incorporating ESG factors into investment decisions in 2017 were:

- 47%: My fund must consider ESG factors as part of our fiduciary responsibility
- 42%: The fund's investment policy statement dictates that we consider ESG factors
- 32%: We expect to achieve higher returns AND we expect to achieve an improved risk profile

Explicitly documenting ESG factors by way of the investment policy statement (IPS) was a common implementation approach among all fund types except corporate funds. Half of public funds and foundations and 43% of endowments indicated their IPS dictates that they consider ESG factors. Ironically, only 13% of corporate funds' IPS dictated that ESG factors should be considered even though 88% of corporate respondents indicated they must consider ESG factors as part of their fiduciary responsibility.

Reasons Not to Use ESG Factors

More than half (61%) of U.S. institutional investors that responded to our survey in 2017 have not incorporated ESG factors into investment decision-making, in line with 2016 (60%). The most common reason cited in 2017 was that the fund would not consider any factors that are not purely financial in the investment decision-making process (41%).

The next most popular answer in 2017 was that the value proposition for ESG remains unclear (39%), down from 63% in 2016. This was especially true among endowments (86%) that do not incorporate ESG factors into investment decision making.

Reasons For and Against ESG

88%

of corporate funds surveyed utilize ESG factors in order to fulfill their fiduciary duty.

More investors expect to improve their fund's risk profile by applying an ESG lens in 2017 (32%) than fiver years ago (17%).

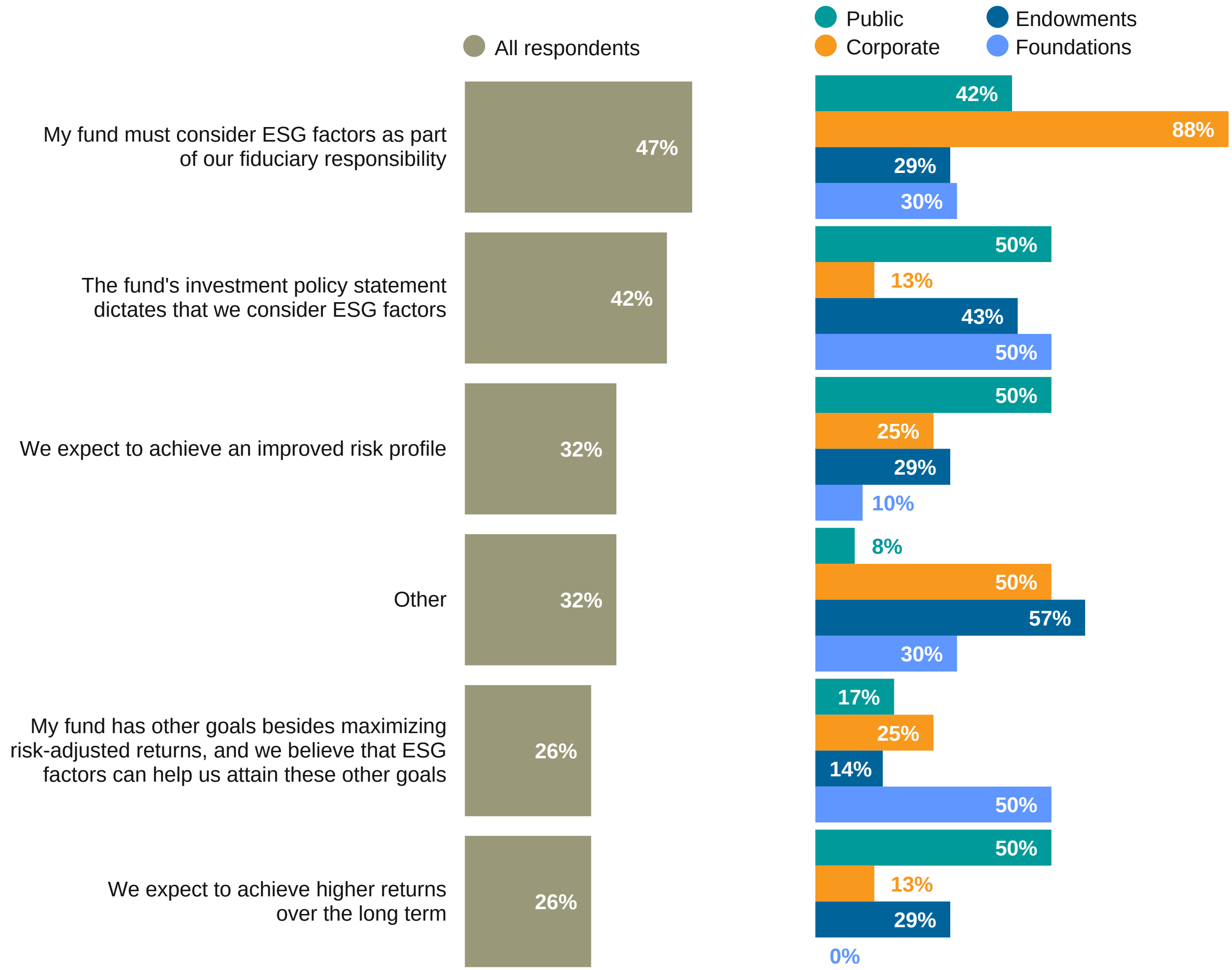
"Other" responses include:

"Participants desire to incorporate"

"We believe it is an important attribute for certain generations of participants"

"Mission alignment with our organization"

Reasons for incorporating ESG factors into the investment decision-making process*



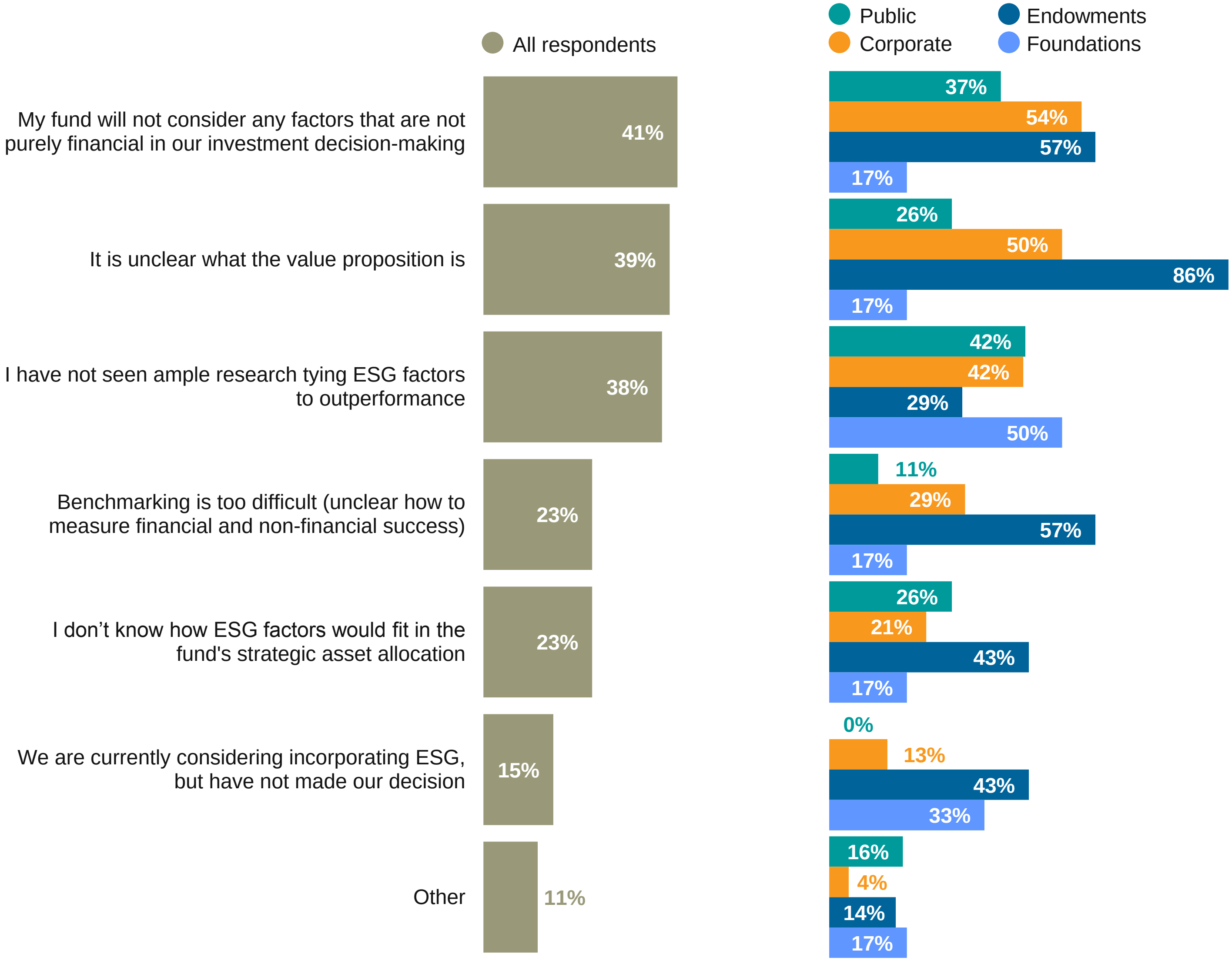
* Multiple responses were allowed.

Reasons For and Against ESG

More clarity

Years of education around ESG by movement proponents appears to be paying off, as the percentage of participants that were unclear of the value proposition of incorporating ESG factors declined from 53% in 2013 to 39% in 2017. However, for endowments this remained the top reason for not incorporating ESG factors.

Reasons for NOT incorporating ESG factors into the investment decision-making process*



* Multiple responses were allowed.

Conclusions

The percentage of U.S. investors that have incorporated ESG factors into decision-making has leveled off at 37% in 2017, on par with 2016 (37%) and up 68% relative to five years ago (22%).

Fund Type and Size Matter: Foundations and endowments have been the greatest adopters of ESG compared to other fund types over the last five years and remained on top in 2017. One-quarter of corporate funds and around one-third of public funds utilized ESG factors in some fashion in 2017, and all fund types have seen increased adoption over the last five years. The larger the fund, the more likely it was to incorporate ESG into investment decisions.

Implementation Varies: How to best implement ESG factors into investment decisions varies substantially from fund to fund, as investors find the approach that best accomplishes their unique goals. The top implementation methods in 2017 were:

- 50%: adding language to the investment policy statement
- 42%: communicating to their investment managers that ESG is important to the fund
- 42%: hiring a manager that has incorporated ESG
- 42%: incorporating a screening process and communicating to investment managers that ESG is important to the fund

Perceptions Change: Years of education around ESG issues and increased awareness of the vast options available to investors have changed how they think about the space. Today fewer investors are unclear on ESG's value proposition than five years ago (39% in 2017 vs. 53% in 2013), and more expect to improve their fund's risk profile by applying an ESG lens (32% in 2017 v. 17% in 2013).

Looking Forward: Climate change, fossil fuel-free investing, and the regulatory environment are a few examples of ESG issues that have been covered by the press in recent years. While fewer survey respondents in 2017 were considering new implementations of ESG in their investment decision-making processes than previous years (7% vs. around one-fifth, historically), perceptions and approaches to implementation have shifted over time. Callan will closely follow these trends as the ESG landscape for data availability and factor integration continues to evolve.

About the Authors

Shane Blanton is a Senior Analyst in Callan's Published Research Group covering business analytics. He is responsible for data analysis and visualization to support Callan's research endeavors. In addition, he is responsible for measuring and benchmarking Callan's communications campaigns. Previously Shane was a member of the Analytical Solutions Group for three years, training Callan's clients to use PEP software.

Prior to joining Callan, Shane worked as an Account Manager for an IC packaging manufacturer, and also worked as a trading assistant to a proprietary options firm. Shane attended Carnegie Mellon University, where he earned a B.S. in Business Administration.

Anna West is a Senior Vice President dedicated to Callan’s research and education initiatives. As Director of the Callan Institute and Co-Manager of the Published Research Group, she oversees the educational content presented at the Callan Institute workshops and conferences. She also works with subject matter experts across Callan to produce white papers, surveys, charticles, and other research for investors. As chair of Callan’s Environmental, Social, and Corporate Governance (ESG) Committee, Anna covers ESG trends and developments. Anna is also a member of Callan's Emerging and Minority, Women, or Disabled-owned Managers Committee and is chair of the Institute Advisory Committee. She is a shareholder of the firm.

Anna joined Callan in August 2006. Prior to Callan, she worked for Vail Resorts, Inc. She earned an MBA from the University of San Francisco and a BA in International Business and French from Washington University.

Disclosure

About Callan

Callan was founded as an employee-owned investment consulting firm in 1973. Ever since, we have empowered institutional clients with creative, customized investment solutions that are backed by proprietary research, exclusive data, and ongoing education. Today, Callan advises on more than $2 trillion in total fund sponsor assets, which makes it among the largest independently owned investment consulting firms in the U.S. Callan uses a client-focused consulting model to serve pension and defined contribution plan sponsors, endowments, foundations, independent investment advisors, investment managers, and other asset owners. Callan has five offices throughout the U.S. For more information, please visit www.callan.com.

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The Callan Institute, established in 1980, is a source of continuing education for those in the institutional investment community. The Institute conducts conferences and workshops and provides published research, surveys and newsletters. The Institute strives to present the most timely and relevant research and education available so our clients and our associates stay abreast of important trends in the investments industry.

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ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES IN INVESTING

A Guide for Investment Professionals

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ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES IN INVESTING

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Contents

Abstract

The practice of considering environmental, social, and governance (ESG) issues in investing has evolved significantly from its origins in the exclusionary screening of listed equities on the basis of moral values. A variety of methods are now being used by both value-motivated and values-motivated investors in considering ESG issues across asset classes. There is, however, a lingering misperception that the body of empirical evidence shows that ESG considerations adversely affect financial performance. For investment professionals, a key idea in the discussion of ESG issues is that systematically considering ESG issues will likely lead to more complete investment analyses and better-informed investment decisions.

Introduction

A critical factor in the financial performance of investments is the investor's ability to identify drivers of the expected risk and return of investments. Financial analysts and portfolio managers are expected to be familiar with the financial factors that drive the value of an investment. However, issues that are difficult to measure in monetary terms and that do not form part of traditional financial metrics also affect the risk and return of investments—at times, decisively. In general, they are referred to as *environmental*, *social*, and *governance* (ESG) issues.

ESG issues are often highlighted by news media when investors suffer sudden and substantial losses on listed equities—losses that are attributed to poor management of risks posed by one or more of these ESG issues. For example, at a number of companies—including Petrobras, Enron, Banco Espírito Santo, Parmalat, and Toshiba—governance risk has proved costly for investors.

Regarding environmental risks, the health and safety record of BP in the run-up to the Gulf of Mexico oil spill in 2010 was worse than that of its peer group. When this fact was brought to the fore after BP's share price had fallen, it reinforced the need to analyze ESG performance indicators. The ongoing drought in California has also re-emphasized the need to consider water stress, a prominent ESG issue, in investment analyses for the businesses concerned, from agricultural farming to semiconductor manufacturing. Concerns about climate change and fossil fuel assets becoming stranded are finding expression in shareholder resolutions at the annual meetings of large oil companies, such as Shell.

In addition, social issues (e.g., labor relations) can have a significant and direct impact on a company's financial performance—for instance, the South African mining company Lonmin experienced a breakdown in its relationship with its workforce in 2012. For other companies, labor relations may have an indirect impact through reputation—for example, Walmart is frequently criticized for its labor practices.

In the past, the governance issues were seen as relevant mainly for *value*-motivated investors and the environmental and social issues as relevant mainly for *values*-motivated investors. Not anymore. There is a growing realization that whether motivated by economic value or moral values, ESG issues are relevant for all long-term investors.

Although ESG issues often receive attention owing to extreme events that cause sharp drops in the stock prices of relatively large listed companies, they are *not* confined to equities, extreme events, or large companies. The ESG issues and related megatrends, such as scarcity of a natural resource (e.g., potable water) and changing demographics (e.g., the economic rise of pro-sustainability millennials), are relevant to investment risk and return across asset classes.

For investment professionals, a key idea in the discussion of ESG issues is that systematically considering ESG issues will likely lead to more complete analyses and better-informed investment decisions.

This guide is divided into three chapters. Chapter 1 provides background information needed to understand ESG considerations in investing, Chapter 2 explains the application of different methods of considering ESG issues, and Chapter 3 explores salient issues in the debate on ESG considerations.

1. Background: ESG Issues in Investing

This chapter provides the context for this guide as well as shares information needed to understand the discussion on ESG issues in investing.

1.1. Context and Objectives of This Guide

CFA Institute has been educating investment professionals on governance issues in investing for many years. In 2005, CFA Institute published "The Corporate Governance of Listed Companies: A Manual for Investors," which was followed by a second edition in 2009.

In 2008, with the growth in the body of knowledge on social and environmental issues, CFA Institute published "Environmental, Social, and Governance Factors at Listed Companies: A Manual for Investors." The focus of the publication was how to integrate ESG risk and opportunity issues into a fundamental analysis of listed equities. Since then, CFA Institute has continued to produce educational content on ESG issues in investing in a variety of forms (e.g., short books, articles, conference proceedings, video, and audio). A number of CFA Institute members in different parts of the world who are on the cutting edge of the practice of considering ESG issues in investing have been keen to work with CFA Institute to produce more educational content in this area. There is also interest in knowing the perspective of members regarding ESG considerations in investments. Since 2013, CFA Institute has been pursuing its Future of Finance initiative,[1] a global effort to shape a more trustworthy, forward-thinking financial industry that better serves society. These developments, together with a perceived need for a brief guide for investment professionals on the state of ESG considerations in investing, have led to the publication of this guide. As stated by Paul Smith, CFA, president and CEO of CFA Institute:

> CFA Institute believes that every investment analyst should be able to identify and properly evaluate investment risks, and ESG issues are a part of this evaluation, our exam curriculum emphasizes risk management, and our members are increasingly interested in continuing education materials on ESG.

[1]See www.cfainstitute.org/FutureFinance.

In this context, the objectives of this guide are to (1) serve as a primer for investment professionals on ESG considerations in investments across asset classes, (2) inform the reader of the state of the discussion and practices regarding ESG considerations in investments, and (3) share the views of CFA Institute members regarding ESG considerations in investments.

Throughout this publication, we refer to the results of a survey of CFA Institute members on ESG issues. On 26 May 2015, 44,131 members who are portfolio managers and research analysts were invited via email to participate in an online survey. The survey closed on 5 June 2015; 1,325 valid responses were received, for a response rate of 3% and a margin of error of ±2.7%.

This guide was written in collaboration with practitioners who specialize in ESG issues. Some case studies included in this guide were contributed by these professionals and are duly sourced to them.

1.2. Examples of ESG Issues

There is no one exhaustive list of ESG issues. ESG issues are often interlinked, and it can be challenging to classify an ESG issue as only an environmental, social, or governance issue, as **Table 1** shows.

These ESG issues can often be measured (e.g., what is the employee turnover for a company?), but it can be difficult to assign them a monetary value (e.g., what is the cost of employee turnover for a company?).

Table 1. Examples of ESG Issues

Environmental Issues	Social Issues	Governance Issues
Climate change and carbon emissions	Customer satisfaction	Board composition
Air and water pollution	Data protection and privacy	Audit committee structure
Biodiversity	Gender and diversity	Bribery and corruption
Deforestation	Employee engagement	Executive compensation
Energy efficiency	Community relations	Lobbying
Waste management	Human rights	Political contributions
Water scarcity	Labor standards	Whistleblower schemes

1.3. ESG Considerations Are Not New

The consideration of ESG issues in investing for economic value is not a new phenomenon. Many investors have long considered such issues in fundamental investment analysis by including an assessment of reputational risk, regulatory developments, or such megatrends as an aging population. Some ESG analysis is also built into traditional analytical frameworks, such as Porter's Five Forces. The modern references to ESG analysis, however, refer to a systematic consideration of relevant and material ESG issues rather than to a cursory inclusion of one or more of them. The consideration of ESG issues is a complement to (not a substitute for) traditional fundamental analysis, and ESG issues remain relevant throughout the investment process—from the initial analysis to the buy/sell/hold decision to ongoing ownership practices.

Because of the prominence of large corporations in the global economy and the large proportion of corporate securities held by fiduciary investors, as well as the challenge of trust in finance,[2] there is also a sustained interest in ESG issues in investing by civil society, policymakers, and, of course, news media.

1.4. Various Labels, Same Issues

Various labels are used to describe investments that consider ESG issues, from the relatively traditional *socially responsible investing* to the more recent *responsible investing* and *sustainable investing*. Traditional socially responsible investing is most closely associated with avoiding morally questionable businesses, whereas sustainable investing is usually characterized by identifying investment risks and opportunities with the help of ESG analysis. There is, however, a lack of consistency in the use of such labels, and different labels can be used to mean overlapping ideas. Today, those who say they practice socially responsible investing describe it in much the same way as those who say they practice sustainable investing. The common theme underlying the various labels is an emphasis on ESG issues. Therefore, in this guide, we use the relatively neutral term ESG issues to remain focused on how these issues need to be considered for a more complete investment analysis and better-informed investment decisions regardless of how the investment may be labeled.

[2]See www.cfainstitute.org/learning/future/getinvolved/Pages/investor_trust_study.aspx.

1.5. Moral Values vs. Economic Value

Investors consider ESG issues for various reasons. Some may see them solely as economic risks and opportunities—a source of economic value. Others may see ESG issues not just as risks and opportunities but also as a matter of moral values. Those motivated by moral values may not wish to become complicit in actions they find objectionable or may actively attempt to make a positive impact on society or the environment. For instance, regardless of the economics of investing in the tobacco industry, an individual investor or a health-related charity may find investing in tobacco unacceptable because smoking is harmful to one's health. But other investors may not share the same concerns. They may invest in the tobacco industry if they believe it is an economically attractive investment, and they may look at ESG issues simply to complement their traditional financial analysis. A fundamental point in the "value versus values" debate is that all investors pursue the same *economic value* (even if with different investment objectives and time horizons), but they inevitably have different *moral values*. The different exclusionary screens used in traditional socially responsible investing help explain the different values being implemented in investing.

Both the values-based and the value-based ESG approaches co-exist in investment management. Values-based investing has also shown growth and evolution. For example, consider that in faith-based finance, the global Islamic finance industry is widely reported as one of the fastest-growing segments in finance. Similarly, there is much interest among both investors and policymakers in modern impact investing, which blends value and values. That said, value-based investing is clearly larger than values-based investing.

1.6. Short-Termism

A major and recurring theme regarding ESG issues is that they do not fit well with short-termism in investing—that is, the excessive focus of some corporate leaders, investors, and analysts on quarterly earnings and a lack of attention to long-term value creation. There are structural reasons and practices that cause short-termism in financial markets, most notably, financial incentives and culture. ESG issues do not fit well with short-termism because they tend to affect financial performance over longer periods. For instance, the poor governance of a large company is more likely to affect the company over the long term than in the next quarter. CFA Institute has been covering the issues of short-termism and corporate culture in its publications, and in the interest of brevity, we do not discuss those issues here.[3]

[3] To see our work on short-termism, see www.cfainstitute.org/ethics/topics/Pages/explore_short_termism.aspx.

1.7. Externalities

Whose responsibility are the externalities linked to ESG issues, such as climate change? More specifically, can the burden of externalities be left to governments and regulators to bear alone?

One view is that confronting climate change through government policy, such as the EU's emissions-trading system, has yet to generate the desired results. Investors should not knowingly leave something to governments that governments have yet to deal with effectively and that will inevitably affect the lives of beneficiaries of the investments. Another view is that fiduciary investors cannot be expected to take responsibility for what is beyond their control, and it is unrealistic to bring externalities within the ambit of fiduciary responsibility.

Perhaps a middle ground between these two views on externalities and investment management is the pursuit of "stewardship" along the lines of the UK Stewardship Code, with a "comply or explain" requirement, which "aims to enhance the quality of engagement between asset managers and companies to help improve long-term risk-adjusted returns to shareholders."[4] Another case in point is the Code for Responsible Investing in South Africa, which "gives guidance on how the institutional investor should execute investment analysis and investment activities and exercise rights so as to promote sound governance."[5]

An interesting case in this debate on externalities is the very large investment funds with global portfolios—"universal owners"—that are exposed to the risk that some investments in the portfolio may affect the returns of other investments. For example, some companies might benefit by externalizing environmental costs through pollution, which, in turn, affects other companies, thus affecting the returns of the universal owner's portfolio. Externalities are an economic reason why universal owners should engage with investee companies and policymakers, but the wider debate on externalities and institutional investors is far from settled.

[4] See www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx.
[5] See www.iodsa.co.za/?page=CRISACode.

1.8. Majority Consider ESG Issues

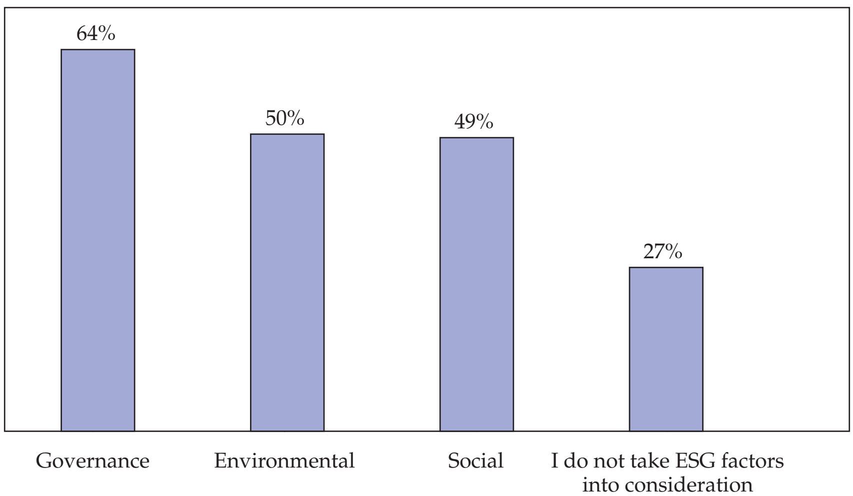
The discourse on ESG issues is based on the premise that these issues, particularly the environmental and social issues, do not receive sufficient consideration in investment decision making. A number of reasons are offered to explain why this is the case. Three stand out:

- It is difficult to assign a monetary value to ESG issues and to integrate them into quantitative models.
- ESG-related disclosure by companies may be limited, unverified, and nonstandardized.
- ESG issues tend to influence financial performance in the long term whereas many investors, as suggested earlier, have relatively short-term horizons.

Despite these challenges, consideration of ESG factors is becoming more common. Evidence points to a growing awareness of ESG issues in investing. In our survey, only 27% of respondents said that they do not consider ESG issues. Thus, 73% consider at least environmental, social, or governance issues, or combinations thereof, in investment decisions (**Figure 1**).

Figure 1. ESG Issues Considered

Which, if any, of the following ESG issues do you take into account in your investment analysis or decisions?

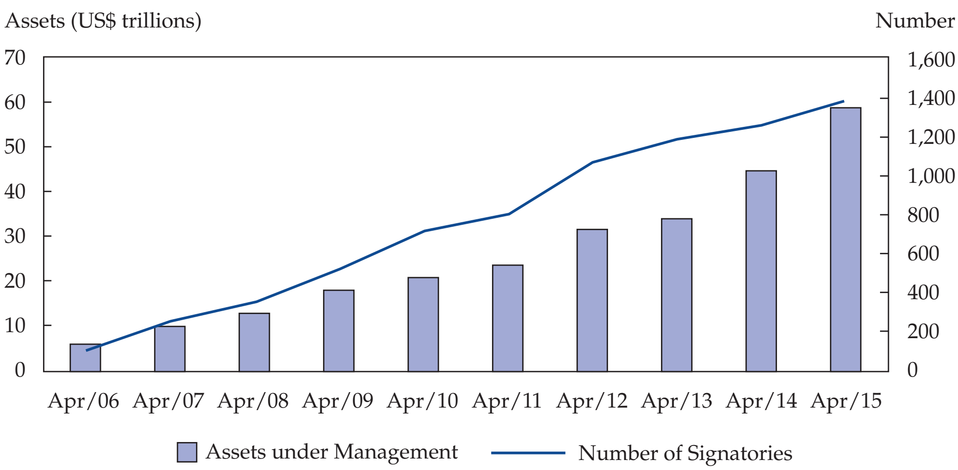


1.9. Awareness Has Been Growing

A well-known indicator of the increasing awareness of ESG issues is the rapidly growing list of signatories to the United Nations–supported Principles for Responsible Investment (PRI), the principal framework for investors who wish to integrate the consideration of ESG issues into their investment decision making. According to PRI, the assets under management (AUM) of its signatories have grown from less than $6 trillion at PRI's launch in 2006 to nearly $60 trillion as of April 2015 (**Figure 2**).

Critics argue that such voluntary consideration of ESG issues results in a reclassification of AUM without a substantive change in how investment decisions are made. Their point is not without merit, and we discuss this criticism later in the guide. But the sheer size of these assets supports the view that many asset owners, investment firms, and professional service providers are giving important consideration to ESG issues in making their investment decisions.

Figure 2. PRI Signatories and Assets under Management

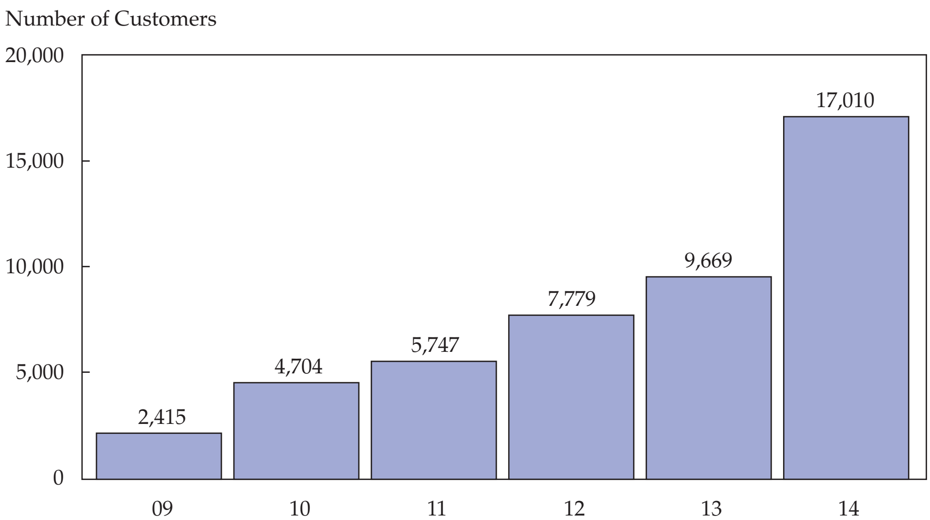


1.10. ESG Data Usage Rising

Another indicator of the growing awareness and consideration of ESG issues is the availability and usage of ESG data and professional services. According to Bloomberg, the number of its customers using ESG data grew by 76% during 2013–2014 (**Figure 3**).

There is a growing number of ESG data and research providers as well as rankings and ratings from both mainstream and specialized providers, such as Reuters, MSCI, and Sustainalystics. Morningstar, a well-known provider of investment research, has announced that it will start offering ESG scores for funds in 2015.

Figure 3. Bloomberg ESG Data Unique Users, FY2009–FY2014



1.11. ESG Issues: To Consider or Not to Consider

Responding to the question, "Why do you take ESG issues into consideration in your investment analysis/decisions?," the highest proportion of survey respondents selected "to help manage investment risks." This response is consistent with the literature on ESG issues, which tends to describe them primarily as risk factors. The fact that clients/investors demand it came in second, which makes intuitive sense. When asset owners demand that investment managers pay attention to ESG issues, managers must take notice. The asset owners could be motivated by value and/or values. Interestingly, "regulation requires it" was selected by only 7% of respondents, supporting the view that the consideration of ESG issues in investing is not led by regulation (see **Table 2**).

We asked those who responded that they do not consider ESG issues to share their reasons why. The top two reasons were lack of demand from investors and the immateriality of ESG issues. Not surprisingly, when these respondents were asked what would make them consider ESG issues, the top two reasons were demand from clients/investors and the materiality of ESG issues with respect to financial performance (see **Figure 4**).

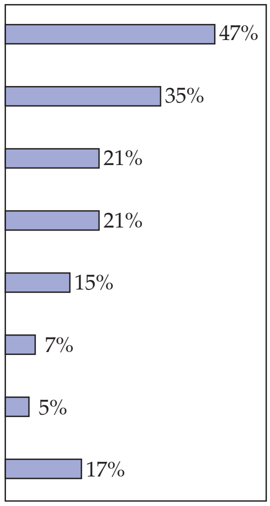
We return to the critical issue of financial performance and ESG issues later in the guide.

Table 2. Why Consider ESG Issues?

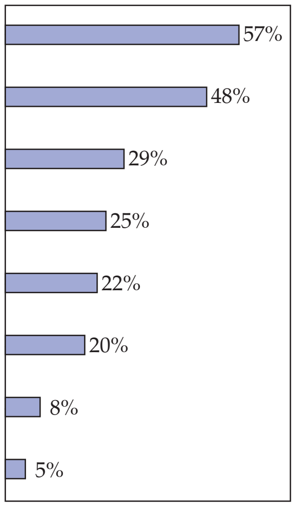
Survey Response	Respondents (%)
To help manage investment risks	63
Clients/investors demand it	44
ESG performance is a proxy for management quality	38
It's my fiduciary duty	37
To help identify investment opportunities	37
My firm derives reputational benefit	30
Regulation requires it	7
Other	5

Figure 4. Reasons for Not Considering/Considering ESG Issues

A. Why do you not take any ESG issues into consideration in your investment analysis/decisions?



B. What, if anything, would cause you to begin considering ESG issues in your investment analysis/decisions?



1.12. Focusing on the Relevant and the Material

There are numerous ESG issues, and an investment analyst must narrow them down to a set of issues that are most relevant and material. This process requires reasoning and empirical work and will vary by sector. For example, utilities face greater exposure to environmental risks than do software providers, just as clothing manufacturers face supply chain challenges concerning labor standards that do not seem to affect the financial services industry. A company that incorporates ESG exposures into its long-term strategic planning and adequately communicates that fact to investors will provide a more complete picture of its prospective value.

Complementing traditional financial analysis with a consideration of ESG issues faces the challenge of the changing relative importance of these issues over time. In spite of this challenge, some industry- and sector-specific ESG performance indicator standards have been developed by such entities as the European Federation of Financial Analysts Societies and the Sustainability Accounting Standards Board.

1.13. Climate Change and Other Environmental Issues

According to the Intergovernmental Panel on Climate Change (2014), the continued emission of greenhouse gases is "increasing the likelihood of severe, pervasive and irreversible impacts for people and ecosystems" and risks posed by climate change would require "substantial and sustained reductions in greenhouse gas emissions." The World Economic Forum's "Global Risks 2015 Report" lists "failure of climate-change adaptation" as number 5 of the "top 10 risks in terms of impact" (World Economic Forum 2015, p. 3).

The risks posed by climate change mean that carbon-intensive energy sources face more regulation and taxation. Future climate change regulations will likely touch many sectors, including those outside carbon-intensive industries—most prominently, insurance.

Although climate change may be the most prominent environmental issue facing investors, it is clearly not the only one. In the CFA Institute survey, respondents rated environmental degradation and resource scarcity above climate change (see **Figure 5**).

1.14. Social Issues Affect More Than Reputation

Social issues play an increasingly important role in the public's perception of investments. News of a poor health and safety record or oppressive labor practices can damage a company's reputation and thus its profitability. Similarly, social trends, such as a growing concern about obesity, are likely to affect the long-term prospects of such sectors as food.

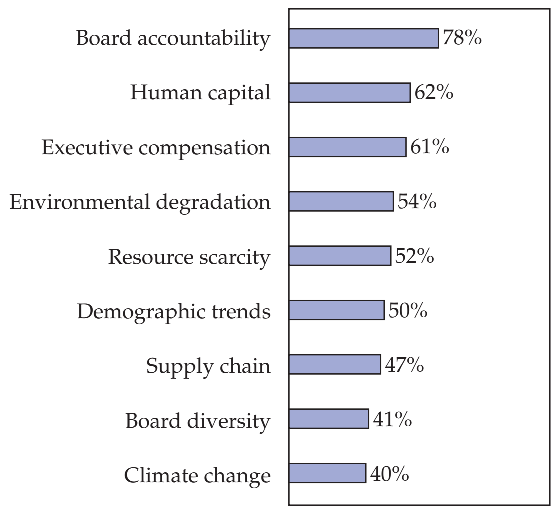
The effects of social issues, however, are not confined to reputation. A breakdown in a company's relationship with labor or the communities it operates in can hurt its profitability. But the effects need not be permanent. Companies can change their practices and convince their stakeholders and investors that they have done so. A case in point is Nike: In the 1990s, Nike was associated with sweatshops in its supply chain in developing countries but took corrective measures to address the issue.

1.15. Governance Issues Widely Considered

Governance issues tend to remain relevant and material across companies and sectors. Historically, among the ESG issues, corporate governance has been covered the most in business and finance curricula and in investment research and analysis. In our ESG survey, respondents also cited a governance issue—board accountability—first when asked which set of issues they consider. Nevertheless, social issues (e.g., human capital) and environmental issues (e.g., environmental degradation) also appear among the issues rated highest by respondents (see Figure 5).

Figure 5. Relative Importance of ESG Issues

Please rate the following ESG issues in terms of importance to your investment analysis/decisions on a scale of 1 to 5, where 1 is not important at all and 5 is very important.



The top rating given by these investment professionals to board accountability, followed by a mix of social and environmental issues, differs from the impression generated by some of the ESG news flows, which often center on climate change.

1.16. Principles, Standards, and Advocacy

A number of principles, standards, and conventions—and associated advocacy organizations—serve as a common reference point for investors considering ESG issues, including PRI (mentioned earlier), UN Global Compact, Equator Principles, OECD Guidelines for Multinational Enterprises, International Labor Organization Declaration on Fundamental Principles and Rights at Work, SA 8000 (auditable social certification standards for decent workplaces), and ISO 26000 (guidance on how businesses and organizations can operate in a socially responsible way). Some investors use these frameworks in applying ESG methods, such as exclusionary screening and active ownership. Others are likely to refer to them in ESG integration.

There are also organizations in different parts of the world that are working to promote ESG considerations in investing. These include the Global Sustainable Investment Alliance (including USSIF and Eurosif), Global Reporting Initiative, Sustainability Accounting Standards Board, World Resources Institute, International Integrated Reporting Council, CDP (formerly, Carbon Disclosure Project), Accounting for Sustainability, Global Impact Investing Network (GIIN), and International Corporate Governance Network, among many others.[6]

1.17. Law and Regulation

A range of laws and regulations pertaining to ESG issues are already in place—and more keep coming. A 2013 study by KPMG, the Centre for Corporate Governance in Africa, the Global Reporting Initiative, and UNEP states that there are 180 laws and regulatory standards in 45 countries pertaining to corporate sustainability reporting; of those, 72% are mandatory (p. 8). A prominent example is the codes of corporate governance used in different parts of the world. Other examples include the exclusion of controversial weapons (Belgium), a stewardship code for institutional investors (United Kingdom), and disclosure of CSR (corporate social responsibility) activities of listed companies (Malaysia). A recurring development, in various parts of the world, is a requirement that investors

[6]For more information about some of these organizations, see http://bit.ly/ESG-orgs.

disclose to what extent they consider environmental and social issues in investment decisions and shareholder rights.

1.18. Relevance across Asset Classes

Most of the discourse on ESG issues has been focused on listed equities, but the practice of considering ESG issues with respect to other asset classes, most notably fixed income, is growing.

In fixed income, ESG issues are mostly about risk. ESG analysis in fixed income considers how such issues as carbon emissions, labor relations, and corruption might affect issuers' creditworthiness. A useful reminder is the case of the mining company Lonmin. After violent labor conflicts in Marikana, South Africa, in 2012, the company was forced to issue a warning regarding the servicing of its debt. Thus, risk pertaining to social issues, which could easily be overlooked in a traditional financial analysis, could also prove costly for fixed-income investors.

As in equities, governance in fixed income is the most analyzed of the ESG issues. For example, in an emerging-market high-yield corporate debt issue, fixed-income investors need to understand the full corporate structure and governance of the issuing entity and related entities before making any investment decision.

In recent years, such organizations as PRI and INSEAD have put together some case studies on ESG considerations in other asset classes, including private equity, but more needs to be done to clarify how to consider ESG issues across asset classes.

2. Application: The Six Methods for Considering ESG Issues

In Chapter 1, we discussed background information on ESG considerations in investing. In Chapter 2, we explain how ESG considerations in investing are being implemented. Investors use six methods for bringing ESG considerations into their decision making: exclusionary screening, best-in-class selection, thematic investing, active ownership, impact investing, and ESG integration. These methods are not mutually exclusive and are often used in combinations. They are used by both value- and values-motivated investors.

2.1. Exclusionary Screening

Exclusionary screening refers to avoiding securities of companies or countries on the basis of traditional moral values (e.g., products or services involving alcohol, tobacco, or gambling) and standards and norms (e.g., those pertaining to human rights and environmental protection). In values-based exclusions, the focus is on the business of the company, and entire sectors are excluded. In norms-based screening, the focus is on the company's behavior regarding internationally accepted norms in such areas as human rights and labor standards. Where such values-based avoidance is built into the governing legislation (e.g., a ban on financing controversial weapons), exclusionary screening can also become a legal obligation.

Exclusionary screening is the oldest ESG method. An important point to note regarding exclusionary screening based on values and norms is that the particular security will not be invested in regardless of how economically attractive it may become. The remainder of this section is derived from the descriptions provided by MSCI in 2014 in explaining the values-based and norms-based exclusions for its ACWI Select Global Norms and Criteria Index.

Exclusions for the ACWI Select Global Norms and Criteria Index

Companies involved in (1) serious violations of widely accepted international norms of responsible corporate behavior and (2) certain controversial business activities are excluded. The norms-based exclusions are defined as violations of standards related to human rights, working conditions, the environment, anti-corruption, and control of weapons. The business activities exclusions are for involvement in alcohol, gambling, tobacco, military weapons, and adult entertainment.

Examples of Violations of International Norms

Human rights: Companies involved in serious violations of internationally accepted norms concerning fundamental human rights, as defined in Principles 1 and 2 of the UN Global Compact, are excluded. Such violations include involvement in abuses concerning civil and political liberties, the deleterious impact of a firm's operations on freedom of expression and free speech, and infractions concerning the rights of indigenous peoples. Companies assessed as being involved in "very severe" controversies concerning the following key performance issues are excluded: human rights abuses, support for controversial regimes, freedom of expression and censorship, and impact on local communities.

Working conditions: Companies involved in serious violations of internationally accepted norms concerning fundamental labor rights, as defined in Principles 3, 4, 5, and 6 of the UN Global Compact, are excluded from the index. Such violations include involvement in forced labor, child labor, employment discrimination, and failure to respect employee rights of freedom of association and collective bargaining.

Examples of Involvement in Controversial Businesses

Alcohol: Companies earning greater than 5% of revenues from the manufacture, distribution, or sale of alcoholic beverages are excluded.

Gambling: Companies earning greater than 5% of revenues from (1) owning and/or operating gambling establishments and/or (2) the manufacture or sale of products necessary for the gambling industry are excluded.

2.2. Best-in-Class Selection

Best-in-class selection refers to preferring companies with better or improving ESG performance relative to sector peers. It could be implemented on either the level or the change in ESG performance—that is, investing more in companies with better ESG performance levels or momentum relative to sector peers. Best-in-class methodology is sometimes referred to as positive selection or positive alignment. In the remainder of this section, we discuss the application of best-in-class selection by NN Investment Partners.[7]

[7]Formerly, ING Investment Management; our thanks to Nina Hodzic and Jeroen Bos for contributing information for this section.

Approach to Best-in-Class Selection

NN Investment Partners determines the relative position of companies in their respective industry by using ESG scores, which are based on both the opportunities and the risks that companies face. ESG criteria comprise around 150 factors, partly depending on the industry. Analysts look at whether a company has ESG policies and management systems in place, whether it has signed up for international initiatives, and what the actual conduct of the company is. For each industry, analysts at NN Investment Partners initially focus on the top 50% of companies in terms of ESG scores in each sector. Selection of companies that are close to the sector average depends on overall portfolio construction features, such as sector and regional risk characteristics and restrictions.

Belief regarding Best in Class

NN Investment Partners believes that the best-in-class method can improve the risk and/or return characteristics of a portfolio. A strong ESG policy makes companies more aware of the various risks they face and increases overall transparency. Companies that score well on ESG issues are often more efficient with lower environmental costs—for example, a lower electricity or water bill. In addition, these companies are expected to have empowered human capital, resulting in higher productivity and a stronger reputation among clients, other stakeholders, and society itself. A strong governance framework secures the legal position of a (minority) shareholder in many ways, which starts to matter in difficult times. A best-in-class methodology needs to be combined with a check on ESG controversies in order to avoid potentially misleading claims, or "greenwashing." Also, momentum in ESG performance is a strong signal of a change in the market's perception of a company. Therefore, both the level of ESG scores and the change in ESG scores over time need to be considered. Two examples of best-in-class companies, included in NN Investment Partners' sustainable equity strategies, follow.

Best in Class: ASICS

ASICS, together with its subsidiaries, manufactures and sells sporting goods. The company is headquartered in Japan. Through constant research and innovation, the company creates products and services that help people enjoy the physical and mental benefits of sports, contributing to a healthy society. ASICS seeks to integrate sustainability as a basic consideration in the design of its processes and products and to improve sustainability throughout the entire value chain. ASICS regularly checks working conditions in its supply chain. ASICS' rating system scores each factory on a range of criteria, such as working hours and health and safety. ASICS' ESG score, as determined by NN Investment Partners on the basis of data from Sustainalytics, is 68.4 versus the industry average of

57.2. The company scores well above average in all three areas (environmental, social, and governance) and shows positive momentum over the years. The company exhibits strong ESG policies, reflecting a commitment to mitigate related risks and impacts. There is significant evidence that corporate behavior at ASICS is in line with its strong ESG policies.

Best in Class: Linde

Linde is a global gas and engineering company headquartered in Germany. The company offers a wide range of compressed and liquefied gases as well as chemicals. Linde develops new applications in close collaboration with its customers, taking into account their specific needs. The company pays particular attention to the environmental impact of its production processes and focuses on making its technical processes and plants more energy efficient. In this way, the company can reduce carbon emissions of its own operations as well as those of its customers. The company has clear targets in the energy efficiency area. An improvement of 0.8% was reached between 2008 and 2012, and a further 0.86% a year is required to meet the 2017 target. The company's water intensity is well below the industry average. Linde's ESG score is 74.7 versus the industry average of 63.3 and shows positive momentum. The company scores well above average in all three areas (environmental, social, and governance). Linde has strong ESG policies and management systems and systematically identifies and controls risks along the product value chain. There is significant evidence that Linde is "walking the talk" with its strong ESG policies.

2.3. Active Ownership

Active ownership refers to the practice of entering into a dialogue with companies on ESG issues and exercising both ownership rights and voice to effect change. Engagement with a company could be for monitoring or influencing outcomes and practices regarding ESG issues. Active ownership is in sharp contrast to the idea that investors should vote with their feet—that is, simply sell off the investments with questionable practices.

Activism varies in terms of aggressiveness of the approach. Some investors may use publicized and confrontational measures, whereas others may prefer a more discreet approach. Note that "active ownership" is not necessarily the same as "activist investing," which may rely more on aggressive measures commonly associated with hedge funds.

The following actions are part of active ownership:

- Vote in shareholder general meetings.
- Write a letter to the company.

- Meet with company representatives.
- Raise a question at a general meeting of the shareholders.
- File a shareholder resolution.
- Attempt to gain a seat on the board.
- Call for an extraordinary/special meeting of the shareholders.
- File a complaint with the regulator/authority.
- Issue a statement to the news media.

Achieving the desired results of active ownership takes time and is not without cost—most notably, staff time—thus, some investors prefer to pool resources and outsource some of the activities related to engagement. Next, we look at case examples of active ownership directly relevant to ESG issues.

JP Morgan Chase's Say-on-Pay Vote

In the United States, say-on-pay votes are mandated by the Dodd–Frank Act. Under the statute, shareholders can endorse or object to executive compensation. Most companies can get majority support for proposed executive compensation. In 2014, according to Towers Watson, the average support for company pay practices was 91%, and only 2% of companies failed to get majority support. In 2015, in the say-on-pay vote at JP Morgan Chase, a record low percentage of shareholders approved the company's pay packages for its executives. This compensation proposal also faced criticism from proxy adviser Institutional Shareholder Services. In total, 61% voted in favor of the measure at the annual meeting—down from 79% in 2014 and 94% in 2013. After the vote, it was reported that JP Morgan's board would consider changes to compensation policies for top executives.

The Church of England and Environmental Standards

In 2013, the Church Investors Group (of the Church of England) continued its engagement program of encouraging companies that operate in carbon-intensive sectors, or that could be considered laggards in comparison with their peers, to report their greenhouse gas emissions to the CDP (formerly, Carbon Disclosure Project) and to adopt emissions-reduction measures. To enable engagement across the whole market, the initiative was based on sending tailored letters to the targeted companies. The program resulted in a

72% improvement in the environmental performance of the 53 companies targeted. An academic assessment of the initiative showed, with 90% confidence, that Church Investors Group members were responsible for the most improvement among the FTSE 250 companies.[8]

Mitigating Governance Risk through Engagement

During 2013–2015, Sparinvest, an asset management firm in Denmark, held a dialogue with the management of a telecom company headquartered in Japan to improve both the substance and the transparency of the latter's anti-corruption strategies, policies, and systems. This engagement between Sparinvest and the telecom company was part of a wider engagement coordinated by PRI. Through meetings and regular communications with management, Sparinvest encouraged the company to improve in a number of indicators, including greater disclosure around whistleblower policies and incidents; the application of anti-corruption policies to contractors, subcontractors, and suppliers; and internal risk assessments and regular monitoring of the internal anti-corruption program. During the period of engagement, the company issued its first annual report with information on the integration of its sustainability and corporate social responsibility practices as well as its first anti-bribery handbook for its increasingly global workforce, covering such risks as facilitation payments. Most significantly, the company issued a clear statement of zero tolerance of corruption. At the beginning of the engagement, in 2013, a third-party provider scored the company—on the basis of public disclosure and a binary scoring method—25% against a series of 18 governance-related indicators. After the engagement with Sparinvest, the company's score rose to 81%.[9]

2.4. Thematic Investing

Thematic investing refers to investing that is based on trends, such as social, industrial, and demographic trends. A number of investment themes are based on ESG issues, including clean tech, green real estate, sustainable forestry, agriculture, education, and health. Although thematic investing is not confined to ESG issues, here we focus on examples of thematic investing that pertain to ESG issues.

[8]Church Investors Group, "Being Good Stewards: Church Investors and Corporate Engagement" (www.churchinvestorsgroup.org.uk/system/files/documents/JamesCorah/CIG-GoodStewards.pdf).
[9]Olivia Mooney, Principles for Responsible Investment; information courtesy of David Orr, Sparinvest.

Profile of a Water- and Air-Themed Fund

This fund is for investors who (1) wish to invest in the shares of companies focused on the water-related sector worldwide, (2) are willing to bear significant variations in market value and thus have a low aversion to risk, and (3) have a long-term investment horizon (at least seven years). It aims to invest in equities issued by companies operating in the water and air sectors worldwide. The companies targeted in the water sector include water production companies; water conditioning and desalination companies; water suppliers; water bottling, transport, and dispatching companies; companies specializing in the treatment of waste water, sewage, and solid, liquid, and chemical waste; companies operating sewage treatment plants; and companies providing equipment, consulting, and engineering services in connection with these activities. The companies targeted in the air sector include those responsible for inspecting air quality, suppliers of air-filtration equipment, and manufacturers of catalytic converters for vehicles. The fund invests at least two-thirds of its total assets in equities issued by companies operating in the water sector.

Profile of an Alternative Energy–Themed Fund

The investment objective of this fund is to provide investors with long-term capital. To achieve this objective, the fund intends to invest at least 80% of its net assets in equity securities of globally based companies involved in the alternative energy or energy technology sectors. Alternative energy includes energy derived from such sources as solar and wind power, hydro-electricity, tidal flow, wave movements, geothermal heat, and biomass/biofuels. Energy technology includes technologies that enable these sources to be harnessed; various kinds of storage and transportation of energy, including hydrogen and other types of fuel cells, batteries, and flywheels; and technologies that conserve energy or enable more efficient use of energy. Fund managers believe that over the next 20 years, the alternative energy sector will benefit from the combined effects of higher energy prices driven by population growth, developing world industrialization, and diminishing fossil fuel supplies; falling costs of alternative energy assets as the technology improves; energy security concerns; and climate change and environmental issues. The fund is a long-only equity portfolio of 30 equally weighted positions.

Profile of a Food- and Agriculture-Themed Fund

This fund seeks to achieve capital appreciation. To achieve this investment objective, it invests in a global and diversified portfolio of investments that provide exposure to the food and agriculture sectors. The fund is permitted to invest in a broad range of instruments, including transferable securities, units in collective investment schemes, exchange-traded funds, and exchange-traded commodities. It intends to take full advantage of the ability to invest directly in derivatives in order to achieve the objective. In particular, the fund is expected to combine core conventional long-only holdings with synthetic equity swaps, contracts for differences for long and short equity positions, stock indexes or stock index options, and equity derivatives and equity derivatives baskets.

2.5. Impact Investing

Impact investing refers to investing with the disclosed intention to generate and measure social and environmental benefits alongside a financial return. According to Global Impact Investing Network, the practice of impact investing has four core characteristics: (1) investors intend to have a social and/or an environmental impact, (2) investments are expected to generate a financial return on capital and, at a minimum, a return of capital, (3) investments are to generate returns that range from below market to risk-adjusted market rate, and (4) investors are committed to measuring and reporting the social and environmental impacts.

The following examples concern Bridges Ventures, an impact investing specialist firm founded in 2002 in the United Kingdom.

Investment Strategy

According to the firm, its

> investment strategy is to focus on opportunities where investments can generate investor returns through helping meet pressing social or environmental challenges—be it backing businesses that generate jobs in underserved markets, or building environmentally friendly care homes for the elderly to sustain an ageing population, or providing flexible financing for innovative community transport models.

The Gym

The Gym pioneered the concept of low-cost gyms in the United Kingdom, opening its first site in 2008. It provides fitness facilities in purpose-built gyms that are open 24 hours and located mainly in underserved areas. The transaction represents a 50% internal rate of return (IRR) and a 3.7× multiple for investors in Bridges funds, of which a minority were rolled over to retain a 25% stake going forward, enabling these investors to benefit from the future growth in the business.

The Hoxton

The investment in the hotel The Hoxton produced employment for one of the bottom 3% of deprived wards in England. More than 70% of The Hoxton staff live in underserved areas. The hotel has won praise and awards from different publications, including *GQ*, the *Guardian*, and Observer Travel Awards. It has consistently achieved 90% or greater occupancy rates for its 208 rooms. The exit delivered a return of £13.3 million to Sustainable Growth Fund I, representing an IRR of 47% and 8.8× the total investment, and £1.9 million to Sustainable Growth Fund II, representing an IRR of 35% and 3.4× the total investment.

SimplySwitch

SimplySwitch is an independent and free online and telephone-based price comparison and switching service that offers consumers immediate, impartial information on the most economical and appropriate gas, electricity, home phone, broadband, and mobile phone suppliers. It was also the first service of its kind to be accessible by telephone as well as the web, making it easier for those who lack the resources or know-how to go online to save money on their household bills. SimplySwitch was sold for £22 million. The exit returned £7.5 million, which represented a money multiple of 22× for investors.[10]

2.6. ESG Integration

ESG integration refers to systematic and explicit inclusion of ESG risks and opportunities in investment analysis. Unlike the best-in-class method, ESG integration does not necessarily require peer group benchmarking or overweighting (underweighting) the leaders (laggards). Similarly, ESG integration does not require any *ex ante* criteria for inclusion or exclusion. The integration of ESG risks and opportunities into investment analysis is relevant for most, if not all, investors. The following are examples of ESG integration.

Valuation of Mining Companies and ESG Risks

When valuing stocks in the mining sector, analysts at Citi Research analyze the management of the relevant ESG issues by the mining companies. In particular, analysts carry out environmental and social impact assessments and closure planning to gauge the quality of the process that mining companies use to assess and manage the environmental and social impacts of a mine throughout its life and beyond. As part of these assessments,

[10]See www.bridgesventures.com/exits.

analysts use environmental indicators (e.g., the ISO 14001, a family of standards that provide practical tools to manage environmental responsibilities) as well as health and safety indicators (e.g., lost production time due to labor injury frequency), along with an analysis of government relations and local economic and community engagement. These analysts are of the view that effective management of ESG risks can significantly reduce mine development lead times, which they see as critical to future earnings capacity. Exercising their judgment, the analysts appropriately adjust the discount rate for mining companies that have lower ESG risks. For example, in one case, the discount rate of a mining company with better ESG management was adjusted from 10.7% to 7.5%, which increased the estimated intrinsic value of its stock by 29%.[11]

Valuation of a Mining Stock and ESG Issues

Anglo American, a mining company with operations spread across a number of countries, has received mixed assessments of its ESG performance. Although some analysts have taken a favorable view of the company's ESG performance for such reasons as its risk mitigation processes and track record on environmental management, others have taken a different view. In 2015, analysts at Robeco, an asset management company, stated that Anglo American scores low on some of its most material ESG issues, such as occupational health and safety and management of local stakeholders. These analysts believe that in platinum mining, Anglo American's profitability is affected by wage inflation and labor strikes. Accordingly, these analysts revised their forecasts of costs upward by 400 bps, which reduced margins by 80 bps and the target price by –7%. In addition, reflecting several ESG factors, analysts at Robeco adjusted the weighted average cost of capital upward by 50 bps, which reduced the target price by –12%. The total impact of integrating ESG risk analysis into the Robeco analysts' estimate of Anglo American's target price is –19%.[12]

Valuation of Utilities and ESG Risks and Opportunities

In the United States, the Environmental Protection Agency's emission and carbon regulations are expected to have a material impact on valuing the power sector. Analysts at ClearBridge Investments believe that these regulations will increase the operational costs of the power plants with higher emission levels (e.g., older, less efficient coal plants) and require additional environmental spending. According to these analysts, incremental expenditures on environmental retrofits should make smaller, older coal plants uncompetitive and lead to their retirement. Implementation of mercury regulations alone could

[11]Justin Sloggett, Principles for Responsible Investment, email message to one of the authors.
[12]Justin Sloggett, Principles for Responsible Investment, email message to one of the authors; our thanks to Willem Schramade, Robeco Asset Management, for permission to use the Robeco information.

lead to retirement of an estimated 17% of the country's coal-fired capacity by 2017. Thus, the companies owning newer plants with lower emissions (consisting of renewables, efficient coal, combined cycle gas plants, and nuclear plants) will be relative winners. The increasing penetration of distributed solar power generation and utility-scale energy storage will have a disruptive effect on utilities over the longer term. For example, NextEra Energy (NEE), the largest wind and solar energy producer in the United States, will see a higher output growth and a more efficient cost structure than some of its peers as it drives earnings growth with these low-carbon energy sources. ClearBridge analysts believe that NEE has an attractive above-average earnings growth rate of 6%–8% and an attractive relative valuation.[13]

Deepwater Horizon and BP Credit Default Swap Spreads

Poor management of ESG factors can contribute to corporate default, price volatility of credit securities, credit rating downgrades, and widening credit default swap (CDS) spreads. Consider the example of BP. On 20 April 2010, the *Deepwater Horizon* oil-drilling platform exploded, killing 11 workers and resulting in a large oil spill, the results of which cost BP several billion dollars. Prior to the catastrophe, some of the ESG research on BP had shown that the company had significant safety and environmental violations at its US operations, including fines. For example, in March 2005, 15 people died and 180 were injured in an explosion at BP's Texas City refinery; in March 2006, there was a massive spill from a BP pipeline at Prudhoe Bay, Alaska. Most investors were not paying attention to the concerns that some ESG research reports had raised. In 2010, as news of the oil spill hit the markets, the BP five-year CDS spread jumped from under 100 bps to as high as 600 bps. Only then did market participants start to pay attention to BP's unenviable record on health and safety. Not only BP's shareowners but also its creditors were affected. Had investors paid attention to ESG research, they could have taken a number of actions to manage BP's higher-risk profile—for example, by underweighting BP in their portfolios or by engaging with BP to improve its health and safety standards.[14]

ESG in Private Equity: Apax Partners

Apax Partners adopted the Private Equity Council's guidelines for responsible investment in 2009 and became a signatory to the Principles for Responsible Investment in 2011. According to Apax Partners, it considers sustainability issues in the early stages of

[13]According to Tatiana Thibodeau, senior analyst at ClearBridge Investments (http://www.clearbridge.com).
[14]Presentation by Christoph Klein on ESG integration in fixed income at the 2015 CFA Institute Annual Conference.

any potential investment opportunity and monitors them throughout its stewardship of the investee company. Apax Partners has a number of initiatives in place in its portfolio companies to reduce complexity, waste, and energy consumption. Two examples, the first pertaining to energy and the second to waste management, follow.

Plantasjen: This company has improved its energy performance by increasing insulation in all newly built stores and by installing heat pumps in six stores in the last 12 months. The increased insulation has reduced the energy consumption of the newly built stores by approximately one-third compared with older stores, and the newly installed heat pumps have reduced energy consumption by approximately 20%.

KCI: This company offers a recycling program for facilities and patients that allows the safe disposal of certain single-patient negative pressure wound therapy (NPWT) devices. KCI provides this recycling program free of charge to the customer. KCI has partnered with Sharps Compliance Inc. to convert customer-recycled KCI single-patient NPWT devices into PELLA-DRX, an industrial resource with a BTU content greater than or equal to that of coal. Therefore, none of the Sharps Compliance–processed medical waste ends up in a landfill; instead, it is repurposed into an industrial resource capable of powering homes and businesses.[15]

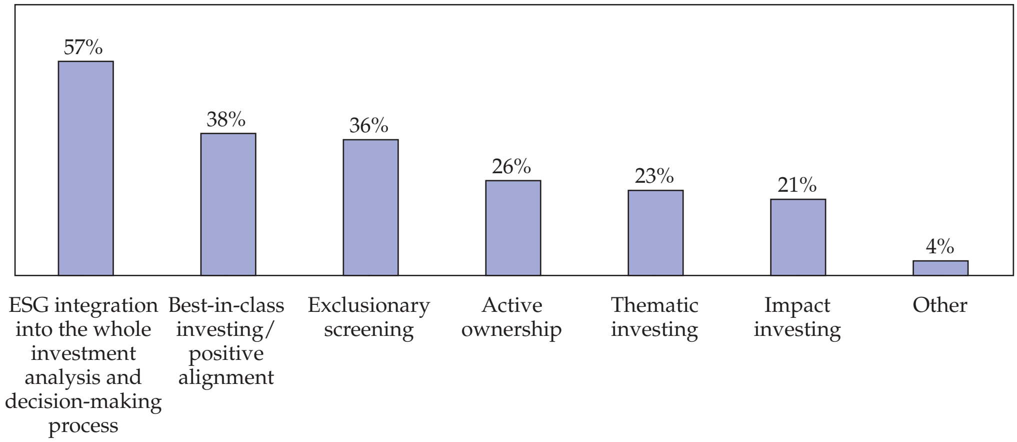
2.7. ESG Integration Used More Widely

Our survey responses indicate that ESG integration is the most used (57%) of the six methods available. This finding contrasts sharply with the perception that ESG issues are only about the exclusionary screening of "sin stocks" (alcohol, tobacco, and gambling). With the signatories of PRI, which emphasizes ESG integration, having nearly $60 trillion (as of April 2015) in AUM, it makes intuitive sense that ESG integration is becoming more common among investment professionals (**Figure 6**).

[15]The case study on Apax Partners was adapted from INSEAD, "ESG in Private Equity: A Fast-Evolving Standard" (2014): http://centres.insead.edu/global-private-equity-initiative/research-publications/documents/ESG-in-private-equity.pdf.

Figure 6. Methods of Considering ESG Issues

A. How do you take ESG issues into consideration in your investment analysis/decisions?



3. Debate: Issues regarding ESG Considerations

In this third and final chapter, we cover a range of issues that come up in the debate on ESG considerations in investing.

3.1. Disclosure Remains a Challenge

Investors can consider ESG issues in their investment decisions only if they have relevant and timely information to do so. At present, mandatory corporate disclosure provides limited information on ESG-related risks and opportunities. The ESG-related disclosure may be released at a different time than the regular financial statements, making integration harder.

It is worth noting, however, that disclosure and data have improved. Some initiatives—such as the Sustainable Stock Exchanges Initiative,[16] which shows how exchanges can work together with investors, regulators, and companies to enhance corporate ESG transparency—are seeking to improve ESG disclosure. Similarly, availability of data is on the rise, even if better quality and greater quantity are needed. For instance, the number of large global companies that disclose their greenhouse gas emissions and water management and climate change strategies to CDP, an environmental nongovernmental organization, rose from 295 in 2004 to 5,003 in 2014.

Our survey shows that for the majority of respondents, public information, third-party research, and company reports are the main sources of ESG information. As many as 61% of respondents agree that public companies should be required to report at least annually on a cohesive set of sustainability indicators in accordance with the most up-to-date reporting framework (**Figure 7**).

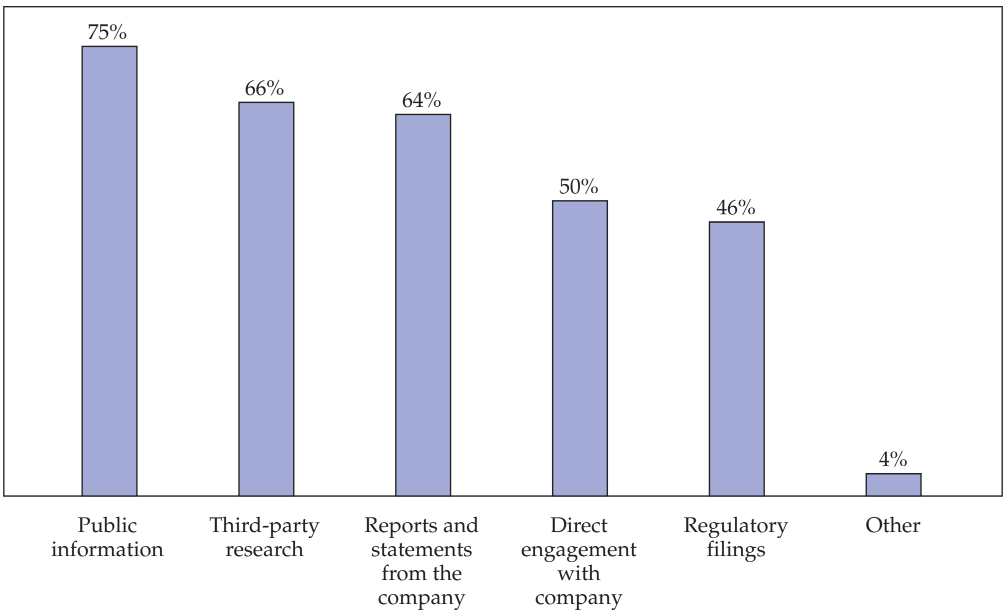
The challenge with voluntary disclosure is that companies may disclose and exaggerate only what reflects well on them and downplay or not disclose what does not. This behavior could both limit ESG analysis and bias it in favor of disclosure rather than performance.

A clear majority (69%) of these respondents agree that ESG disclosures by listed companies should be subject to some level of independent verification. Respondents were divided on whether ESG disclosures should be subject to limited verification or similar to an audit and whether ESG professional services firms or public accounting firms should carry out the independent verification (**Figure 8**).

[16]See www.sseinitiative.org.

Figure 7. ESG Information Sources and Mandatory Reporting

A. How do you get ESG information/data?



B. Do you agree or disagree that public companies should be required to report at least annually on a cohesive set of sustainability indicators in accordance with the most up-to-date reporting framework?

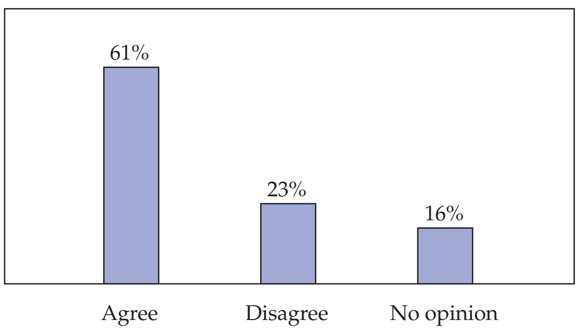
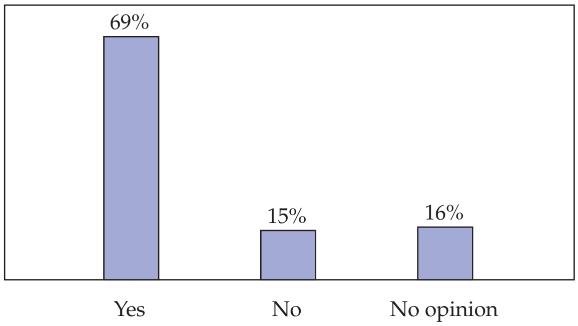
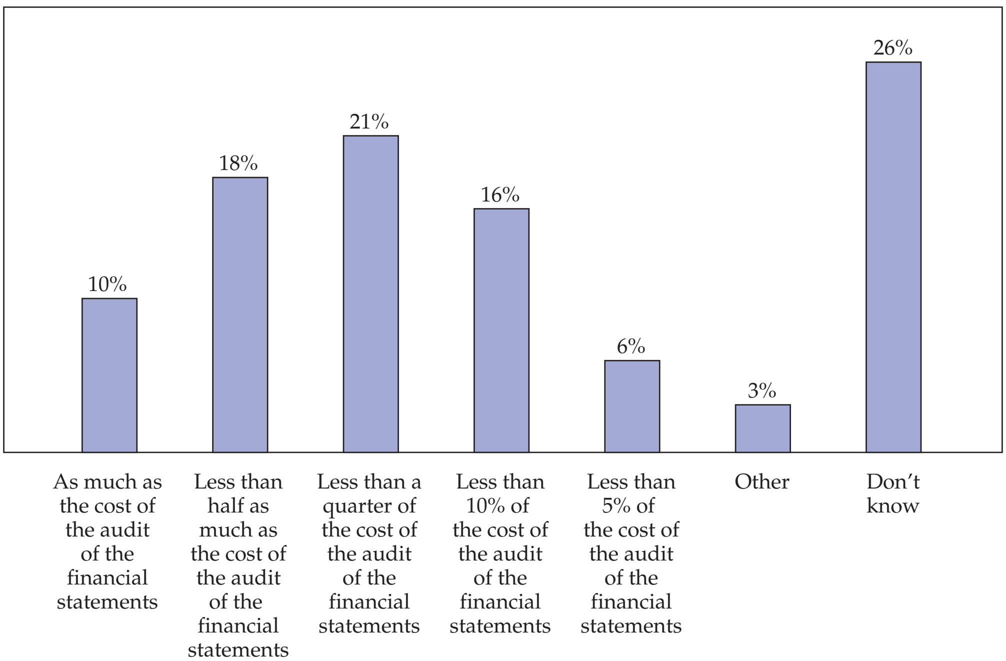


Figure 8. Verification of ESG Disclosures and Its Cost

A. Do you think it is important that ESG disclosures be subject to some level of independent verification of ESG disclosures?



B. Which best represents your view on how much should be spent to obtain independent verification?



Disclosure and independent verification come with a cost. Only 10% of respondents said that listed companies should spend on an ESG audit as much as they spend on an accounting audit.

3.2. Fiduciary Responsibility

The law regarding fiduciary duty varies from country to country and is thus difficult to generalize. Two reports—"A Legal Framework for Integrating Environmental, Social, and Governance Issues into Institutional Investment," also known as the Freshfields Report (2005),[17] and the Fiduciary II Report (2009)[18]—found that considering ESG issues in pursuing economic value is permitted, if not required, by legal interpretations of fiduciary duty. However, there remains some ambivalence on the subject. For instance, in our member survey, when asked why they consider ESG issues, 37% of respondents indicated that they do so because it is their fiduciary duty. Among those who do not consider ESG issues, 22% suggested that they would consider ESG issues if they had clarity that doing so does not conflict with their fiduciary duty.

Based on an analysis of eight countries, including both common law and civil law jurisdictions, in the context of ESG integration, the report "Fiduciary Duty in the 21st Century" contends that "failing to consider long-term investment value drivers, which include environmental, social and governance issues, in investment practice is a failure of fiduciary duty" (Sullivan, Martindale, Feller, and Bordon 2015, p. 9).

The case for the consideration of ESG issues by fiduciary investors is strengthened when the law governing fiduciary duty facilitates it. For example, in South Africa, the updated Regulation 28 of Pension Funds Act 24/1956, effective 1 January 2012, explicitly includes references to ESG considerations:

> A fund has a fiduciary duty to act in the best interest of its members whose benefits depend on the responsible management of fund assets. . . . Prudent investing should give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund's assets, including factors of an environmental, social and governance character.

The reasoning underlying fiduciary responsibility is inevitably linked to what effect ESG considerations have on the financial performance of investments. There is a lingering misperception that the principal ESG method is exclusionary screening, to be used by only values-motivated investors.

[17]See www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf.
[18]See www.unepfi.org/fileadmin/documents/fiduciaryII.pdf.

3.3. Financial Performance

Financial performance is one area that has received substantial, if not the most, attention in research on ESG issues. The Sustainable Investment Research Initiative Library,[19] a searchable database of academic studies, lists hundreds of research papers regarding ESG issues, many of which are on performance.

In 2014, a report by the University of Oxford and Arabesque Partners analyzed about 200 studies to assess how sustainable corporate practices can affect investment returns. It concluded that "88% of the research shows that solid ESG practices result in better operational performance of firms and 80% of the studies show that stock price performance of companies is positively influenced by good sustainability practices" (Clark, Feiner, and Viehs 2014).

There are other such literature reviews and metastudies. The metastudy on ESG issues and performance by Mercer (2009)—"Shedding Light on Responsible Investment: Approaches, Returns and Impact"—reached similar conclusions.

The key point is that, on the whole, the empirical evidence does not support the notion that ESG considerations necessarily adversely affect performance. In the case of ESG integration, this finding makes intuitive sense because, in principle, there should be no adverse impact on performance if it is simply about doing a more complete investment analysis.

3.4. Fossil Fuel Divestment and Stranded Assets

Divestment campaigns have been part of the evolution of ESG considerations in investing. A prominent divestment campaign concerned South Africa's apartheid regime in the 1980s. Such campaigns tend to make their impact by influencing the public discourse, which could result in stigmatization of the companies and sectors involved and, more importantly, changes in legislation affecting them. The latest divestment campaign pertains to fossil fuels in the context of climate change and touches on a range of sectors, from coal mining to steel. Many educational endowments face pressure from students and other stakeholders to divest from fossil fuel. Some endowments have announced decisions to divest, whereas others have announced decisions not to divest. A key point made by divestment campaigners is that one should not be able to profit from injustice. But investment firms' divestment based on moral values raises concerns about fiduciary duty and financial performance.

One area in which the debate on fossil fuel divestment becomes an economic consideration for fiduciary investors is *stranded assets*. There is a risk that some climate-sensitive assets, most notably fossil fuel reserves, could suffer from write-offs or downward revaluations, or

[19]See www.calpers.ca.gov/page/investments/governance/sustainable-investing/siri-library.

conversion to liabilities largely because of regulation. If financial markets do not price the risks of stranded assets, investment performance could be affected.

3.5. Regional Differences

There are perceived differences across (and within) regions on how willing and able investment firms are to address ESG issues in investing. The results of our survey seem to confirm such differences. Some of the responses most favorable to ESG issues tended to come from the Europe, Middle East, and Africa (EMEA) region and the Asia-Pacific region and the least favorable from North America. A relatively high proportion of survey respondents in the Asia-Pacific region consider ESG issues (78%), followed closely by members in the EMEA region (74%). Respondents in the Americas region are the least likely to use ESG information in their decision-making process, but even there, a solid majority (59%) do consider ESG issues. The proportions of respondents who do not take ESG issues into consideration (33%) and do not think ESG training is necessary (30%) are highest in North America. There is a perception that, on the whole, Western Europe is leading the ESG practice. These regional differences could obviously change over time, and the reasons behind these differences are not well understood. For instance, in developed markets with relatively strong regulation, investors could arguably be assuming that some of the ESG issues are being taken care of through regulation.

3.6. Innovations in Impact Investing: Green Bonds and Social Impact Bonds

The green bonds market came into being in 2007 with the help of multilateral banks. Green bonds enable capital raising and investment for new and existing projects with environmental benefits—but they are a process rather than a product. That's because the Green Bond Principles,[20] their chief framework, are a set of voluntary guidelines about process. Although this market segment has grown quickly, a key question facing green bonds concerns *additionality*—that is, whether green bonds finance projects that would not be funded otherwise. With estimated issues below $100 million a year in 2015, green bonds remain a small niche in the overall fixed-income market.

Another innovation in impact investing is social impact bonds, the first of which was launched in 2010. A social impact bond is a contract between a special purpose vehicle and the government in which the government commits to pay for improved social outcomes,

[20]See www.icmagroup.org/Regulatory-Policy-and-Market-Practice/green-bonds/green-bond-principles.

such as reduced recidivism rates for prisoners. Social impact bonds give investors a chance to address social problems through investing. They strike a balance between giving money away altruistically and seeking a financial return solely for one's own benefit—an economic return plus a social return. The market for social impact bonds is estimated to be much smaller than the market for green bonds.

3.7. ESG Issues and Passive Investing

Although ESG issues have historically been associated with active investing, they are also relevant to passive investing or, more generally, rules-based investing. Investors can benefit from ESG considerations when they are integrated into the benchmark index. A number of such indexes are being offered. In addition, passive investors can use active ownership to manage their ESG risks. However, they need a policy and systems to ensure that different investment managers do not take opposing positions while exercising active ownership on behalf of the same asset owner.

3.8. Modern Applications: Smart Beta

ESG methods are being used with such techniques as smart beta. In the context of equity indexes, smart beta generally refers to weighting schemes that do not use market capitalization. There have been attempts to apply smart beta together with ESG criteria. One way to construct a smart beta ESG index is to use an alternative weighting to stocks already selected for higher ESG ratings. One such low-volatility smart beta ESG index was launched in 2015,[21] which measures the performance of the 50 least volatile from within a selection of sustainable stocks and excludes alcohol, tobacco, gambling, armaments and firearms, and adult entertainment. Another way to build it is to first filter stocks using such criteria as low volatility and then apply ESG criteria for the alternative weighting scheme.

3.9. Obstacles to Practical Implementation

There is some criticism of how ESG issues are taken into consideration. Some of the criticism echoes the arguments that environmentalist and entrepreneur Paul Hawken made against socially responsible investing in 2004. Hawken said that "the cumulative investment portfolio of the combined SRI [socially responsible investing] mutual funds is

[21]"S&P Dow Jones Launches Smart Beta ESG Index," *Global Investor* (30 March 2015): www.globalinvestormagazine.com/Article/3441004/S-P-Dow-Jones-launches-smart-beta-ESG-index.html.

virtually no different than the combined portfolio of conventional mutual funds" (Hawken 2004, p. 16). The implication is that if every company can be deemed investable using one method or another, the credibility of "responsibility" suffers.

There is no denying the inherent subjectivity of ESG consideration, just as there is no denying the inherent subjectivity of active investing in general. However, the degree of subjectivity regarding both process and outcome remains an ongoing challenge for ESG integration. Two analysts applying discounted cash flow analysis may reach very different valuations, but there is reasonable clarity on what process they follow, and there are long-standing textbooks that explain this process. The same is not true of ESG integration. If "responsible" portfolios include investments with contested ESG performance, the greater subjectivity exacerbates the concerns about credibility.

The practice of considering ESG issues needs more clarity on how to apply ESG methods—most notably, ESG integration. Of course, it can be understandably difficult to use evidence-based cause-and-effect attribution for ESG methods. Demonstrating how values-based exclusionary screening leads to avoiding certain businesses is relatively straightforward, but demonstrating how value-based ESG integration leads to better-informed investment decisions is more complex. Without understating this difficulty, not attempting to document how ESG integration informs investment decisions will not help its cause.

It is important not to exaggerate the benefits of ESG analysis. It faces some of the same limitations as traditional analysis and may not necessarily lead to investment insights. For example, BP scored high in some ESG ratings before the *Deepwater Horizon* catastrophe in 2010. Similarly, Volkswagen scored high in some ESG ratings before its emissions scandal came to light in 2015.

Although more disclosure on ESG issues by companies remains a demand by some investors, it is not without debate. One issue is that, although some investors seem favorably disposed to demand more disclosure from listed companies, the disclosure practices of investment management firms and asset owners regarding ESG issues are not known to be much better. One argument suggests that for investors to make the case for greater disclosure more convincing, they need to demonstrate that they are willing to walk the talk themselves.

There is an expectation among those interested in ESG issues that as more and more investors consider ESG issues, more pressure is placed on the companies they invest in to improve their ESG performance—which should both reduce risk for investors and make the world a better place. There is, however, an ongoing tension between authenticity and mainstreaming. If an increasing proportion of global AUM claims to consider ESG issues without attributable difference in investment decision making or in the behavior of investee companies, it will not help build the credibility of ESG considerations.

3.10. The Challenge of ESG Education

Those who might consider ESG issues in investing remain in need of more education and training. A little over half (53%) of respondents indicated that employees at their firm do not receive training on ESG issues (**Figure 9**).

Of those who do, the most common ways are miscellaneous sources (e.g., conferences and publications) and learning by doing (**Figure 10**). A low level of training and formal education does not breed confidence in how rigorously ESG issues are being considered in investment analysis.

Although the literature on ESG issues covers their effect on financial performance extensively, there remains a gap regarding how to consider ESG issues in practice. Perhaps expanding on the "how to" should now rank higher on the ESG research agenda.

Figure 9. Employee Training on ESG Issues

Do any employees at your firm receive training on how to consider ESG issues in investment analysis/decisions?

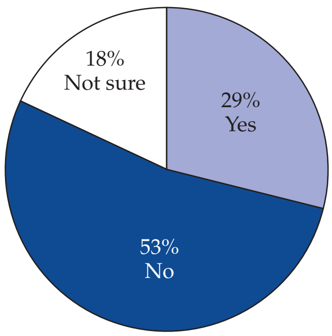
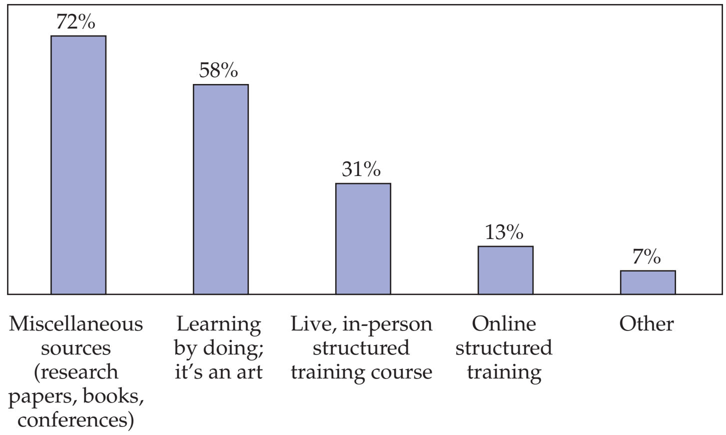
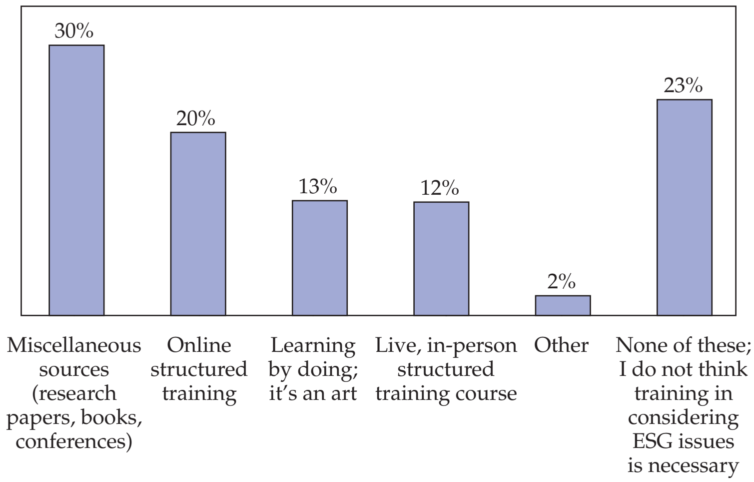


Figure 10. Modes of Training on ESG Issues

A. How do employees at your firm receive training on how to consider ESG issues in investment analysis/decisions?



B. If you would like employees at your firm to receive training in considering ESG issues, what would be your preferred mode?



3.11. ESG Education and CFA Institute

CFA Institute believes that every investment analyst should know about the investment risks and opportunities posed by ESG issues. CFA Institute helps investment professionals better understand ESG issues in investing through its educational programs—most notably, the CFA® Program—and learning opportunities for continuing professional development (CPD).

ESG Content in the CFA Program Curriculum

Like any other topic, the ESG content in the CFA Program is determined by the practice analysis process,[22] whereby CFA Institute determines what should be included in the CFA Program through a survey of investment practitioners. Although the CFA Program curriculum changes from year to year, the 2015 curriculum has the following readings that directly address ESG issues/responsible investing:

- **Level I:** Volume 4—Corporate Finance and Portfolio Management, Corporate Finance, Study Session 11, Reading 40, The Corporate Governance of Listed Companies: A Manual for Investors (Note: The reading is devoted to corporate governance.)
- **Level II:** Volume 3—Corporate Finance, Reading 26, Corporate Governance (Note: The reading includes a section specific to ESG risks.)
- **Level III:** Volume 4—Fixed Income and Equity Portfolio Management, Reading 24, Equity Portfolio Management (Note: Socially responsible investing is explained at some length.)

Given the increasing interest in ESG considerations in investing, the Education Advisory Committee of CFA Institute initiated a reassessment of the coverage of ESG issues in the Candidate Body of Knowledge,[23] with the goal of identifying the scope and practical implications of ESG investing appropriate for the CFA Program. In 2014, as part of this initiative, four practice analysis sessions were held in London, New York City, Amsterdam, and Hong Kong with ESG experts. The participants at these meetings had considerable expertise in ESG issues and were a rather diverse group in terms of designation (both CFA charterholders and noncharterholders), perspective (buy side, sell side, investor relations, industry associations, and vendors), and market sector (equity, fixed income, and

[22]See www.cfainstitute.org/programs/cfaprogram/courseofstudy/Pages/practice_analysis.aspx.
[23]See www.cfainstitute.org/programs/cfaprogram/courseofstudy/Pages/cbok.aspx.

private equity). Having conducted these practice analysis sessions, we are in the process of updating the ESG-related content in the CFA Program, and we will continue to evaluate the volume and emphasis of ESG issues in the CFA Program curriculum.

CFA Institute CPD ESG Content

CFA Institute has been producing educational content on ESG issues in investing for many years, which is now too extensive to be listed here. We have also been covering some of the key topics that underlie ESG issues, such as short-termism and gender and diversity, without necessarily labeling them ESG content. The CPD methods consist of events, including online events, and a variety of print and digital publications, with both shorter and longer reads. In 2014, we added an online course, ESG-100,[24] to our growing list of ESG-related offerings. The ESG-100 provides questions and answers in a self-quiz format, so you can gain and/or test your understanding of ESG issues in investing. To our knowledge, this course is the only free online course regarding ESG issues. To assist investment professionals in accessing our CPD ESG content, we provide a one-page list.[25]

3.12. Conclusion

Both value-motivated and values-motivated investors consider ESG issues in investment decisions. The practice of considering ESG issues in investing has evolved significantly from its origins in exclusionary screening of listed equities on the basis of moral values. There are, however, some lingering myths about ESG considerations, and the results of our survey have debunked three, as shown in **Table 3**.

Table 3. Myth vs. Reality

Myth	Reality
Investment firms consider ESG issues primarily for reputational reasons.	The top reason investment professionals consider ESG issues is to manage risks.
ESG issues are mostly about climate change.	The top ESG issue investment professionals consider is board accountability.
ESG methods are confined to exclusionary screening.	There are six major methods, of which ESG integration is used most widely by investment professionals.

[24]See www.cfainstitute.org/learning/products/onlinelearning/Pages/103978.aspx.
[25]See www.cfainstitute.org/learning/future/knowledge/pages/esg.aspx.

Important challenges face the evolving practice of considering ESG issues in investing. An obvious and structural challenge, which is not unique to ESG considerations, is short-termism in financial markets. But there are others. For instance, the case for "what" and "why" for ESG considerations has been made with sufficient clarity, but there is a need to clarify "how to" apply ESG methods—most notably, ESG integration—across asset classes.

One objective of this guide is to explain the state of ESG discourse to investment professionals. Although a number of topics are part of the ESG discourse, for investment professionals a key idea in the discussion of ESG issues is that systematically considering ESG issues will likely lead to more complete analyses and better-informed investment decisions.

If you are a member of CFA Institute and you would like to participate in our educational initiatives regarding ESG issues, we invite you to join the CFA Institute members LinkedIn subgroup on ESG issues in investing. To see the continuing professional development resources regarding ESG issues in investing provided by CFA Institute, which are available to both members and nonmembers, please visit http://bit.ly/ESG-learn.

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