DEFINING RESPONSIBLE INVESTING: AN INVESTMENT MANAGER DUE DILIGENCE PERSPECTIVE

Perspectives on evaluating investment managers that incorporate responsible investing in their investment process

As interest expands among investors regarding responsible investing, many questions have been raised. Some questions that will be addressed in this piece are:

- How do you differentiate between ESG, SRI, responsible, sustainable and impact investments?
- How do you evaluate and select responsible investment strategies?
- How do you use responsible investments within a total portfolio?
- What are the differences in risk and return between responsible and traditional investments?

Responsible investing has become increasingly more important among individual investors and asset managers due to a coalescence of several emerging trends. The demographics of the end market, including institutional asset owners and individual investors, are shifting. Among individual investors, younger generations with growing wealth and an increasing percentage of women place value on the role of responsible investments. To fill this demand, asset managers have launched new types of responsible investments tailored to how they view the world and/or how they believe investors view the world.

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From an asset manager's perspective, increased corporate regulation, growing concerns about climate risk, a dwindling supply of natural resources and social media increasing news flow have beckoned for the consideration of environmental, social or governance ("ESG") factors when evaluating investments. Concurrently, there has been improved self-reporting of ESG information, resulting in greater transparency at many corporations over recent years. A small but growing trend has led some companies to incorporate ESG objectives into their governance with a growing number of benefit corporations and B Corps (see below) being incorporated or certified and a handful now having publicly-traded equity.

Perhaps one of the largest hurdles facing US-based ERISA plans was ambiguous language in a 2008 Department of Labor Interpretive Bulletin, which was perceived as discouraging the consideration of ESG factors when evaluating plan investments. In

October 2015, this language was clarified to specifically allow these types of analysis, as long as financial interests are not sacrificed as a result.

With the emergence of responsible investing comes a new set of challenges around identification, definition, methods of implementation and ultimately, reporting.

Throughout the past several years, the manager due diligence we have conducted has given us a great deal of insight into the variety of responsible investment strategies available. There is a myriad of different approaches to ESG integration which stem from the investment organization's philosophy. This, in turn, impacts the resources available, level and type of integration, and reporting on ESG characteristics, including impact measurement. With highly inconsistent definitions of ESG or responsible investing in the market, this piece will attempt to categorize the different methods and explain the nuances of each.

BENEFIT CORPORATIONS AND B CORPS

A benefit corporation is a for-profit corporate entity which is required to consider positive impact on society and the environment in addition to profit as its legally defined goals. In addition to the company's financial performance; a benefit corporation is subject to judgment for social and environmental performance as well. While provisions vary state by state, they typically include the purpose of public benefit, director accountability, transparency of benefit reports at a third party standard and limited right of action. The “benefit corporation” legal status is specific to U.S. companies, while few other countries have similar designations. Presently, 31 states have passed the benefit corporation legislation and seven more are in the process.

As opposed to the legal status of a benefit corporation, a B Corp is a private certification granted by the non-profit organization B Lab. The B Corp certification process entails an assessment of a company's social and environmental performance which must meet a minimum score; requirement that a company amends its governing documents to integrate the B Lab commitments; and pay an annual fee.

The B Corp certification process can be considered a first step to becoming a legal benefit corporation. According to B Corp requirements, a company incorporated in a state where the legislation exists, it is required to adopt benefit corporation status.
Examples of registered benefit corporations include companies dedicated to childhood education, sustainable farming, and natural and organic consumer products.

Advantages of becoming a benefit corporation or B Corp include increased attractiveness to investors, prospective talent and customers, but other benefits may be more idealistic in nature. Because of this, along with an increased reporting burden, it remains to be seen whether these concepts will gain traction in the mainstream business landscape.

DEFINITION

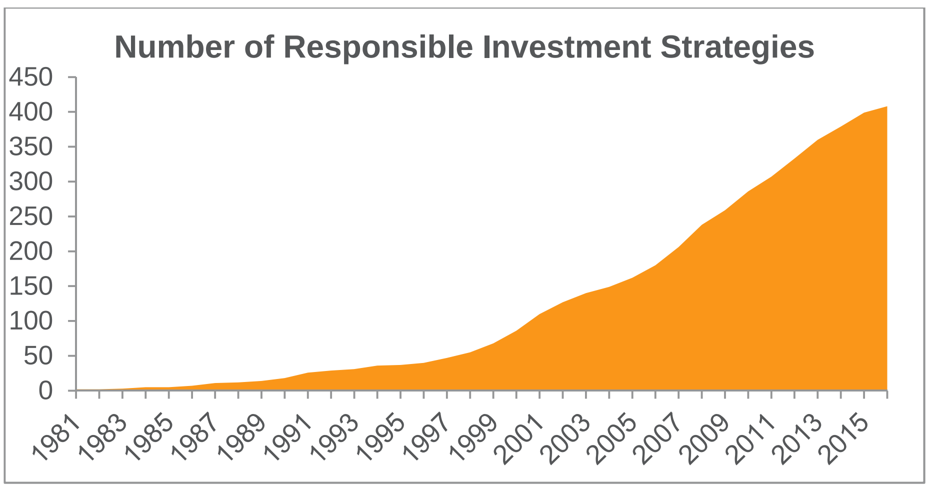
ESG, sustainable, impact investing, among other terms, are many names for what falls under the broad term of responsible investing. Ultimately, different investment strategies will target their own responsible objectives, just as they target their own investment objectives. We will refer to responsible investments when broadly addressing the various groups within the responsible investments category.

Responsible Organizations

As developing new products presents business opportunities, many firms have come to market with their own take on responsible investing. While some firms were founded on responsible investment principles, others have evolved to adopt these principles and others have developed responsible investment capabilities based on client demand. A small subset of asset management firms have responsible investment principles engrained in the firm culture, philosophy and mission statement. This is an important consideration to assess the firm's overall commitment to responsible investing and impact they desire to make.

Responsible Investment Teams

Another component to assessing a firm's dedication to responsible investing is the breadth and depth of resources devoted to thought leadership, security-level analysis of ESG metrics and third-party ESG data sources. We've found that many firms which are focused on responsible investing have dedicated groups tasked with identifying ESG issues relevant to specific regions and industries, staying abreast of evolving regulations and policies, evaluating ESG data providers and systems, and educating their internal investment professionals. Alternatively, ESG analysis may be incorporated into the traditional security analysis, if fully integrated into the research process. Security analysts that are also responsible for the ESG considerations are able to weigh the risks and rewards of an issuer on both a financial and non-financial basis within their areas of coverage.



Source:eVestment Alliance

Responsible Investment Strategies

As there are a number of different philosophies associated with responsible investing, there are different methods and degrees of implementation. For simplicity, we will categorize the types of responsible investments into three categories, as explained below.

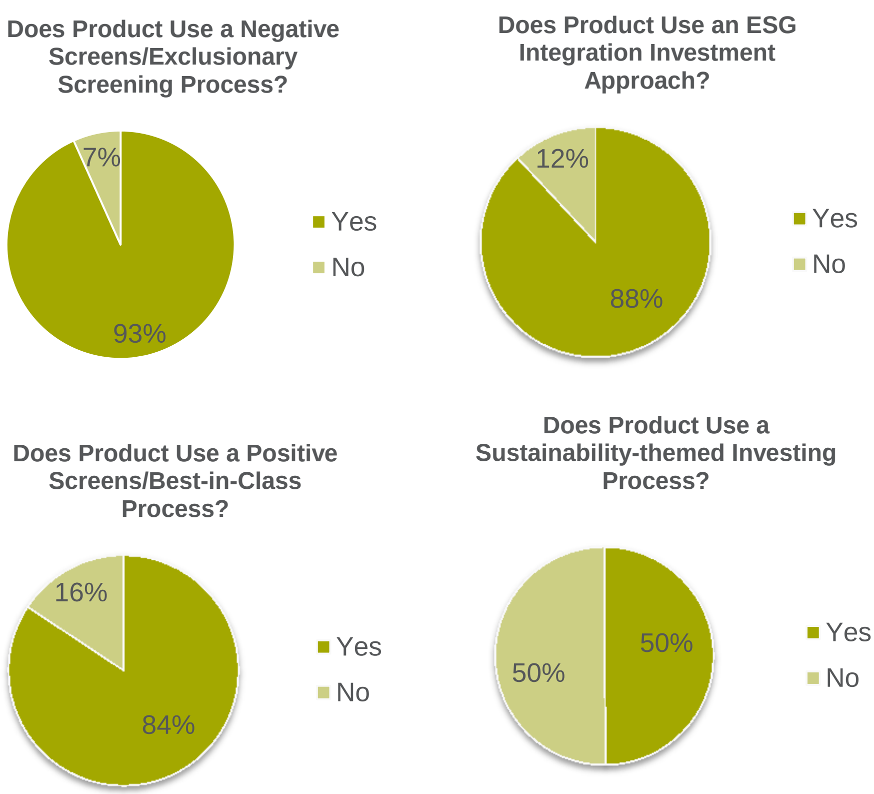
- ***Values-based investing*** incorporates exclusionary screens that filter out companies with negative assessments based on ESG criteria or problematic business practices. This method has been traditionally referred to as Socially Responsible Investing, but can also apply to other sets of values relevant to specific religious and more customized exclusions.
- ***Integrated investing*** incorporates the analysis of the environmental, social and governance aspects of an issuer into the investment process to identify risks and opportunities. In general, asset managers that follow this method believe

that considering ESG aspects is additive to financial performance of their investments.

- ***Impact investing*** seeks to improve global ESG issues alongside financial returns. This can be achieved by simply investing capital with companies that are leaders in creating positive change and adapting to ESG issues. These types of investments can target specific outcomes tied to a single opportunity or multiple projects and initiatives. Examples include a municipal bond tied to developing affordable housing or stock of a solar energy company. Impact investments can also include activist strategies where the investment team engages with company management and/or actively votes proxies.

Historically, values-based exclusions have been the primary approach of responsible investing, and indeed this strategy continues to represent a significant portion of assets managed under these types of mandates. That said, in recent years there has been a shift from values-based exclusions (the first category above), which are distinct from financial analysis, to strategies that incorporate ESG aspects to complement financial analysis. This may be additive to financial performance (the second category above) or achieving a measureable social or environmental impact alongside financial performance (the third category above). This shift is indicative of a broader trend of goals-based investing, where the outcome is the primary consideration. It is important to note that these categories are not mutually exclusive and many responsible investments feature elements across multiple types.

eVestment Survey of ESG-Focused Investment Managers



Source: eVestment Alliance, as of November 4, 2016.

Responsible Research

Many asset managers have begun incorporating ESG factors into their security analysis as a way to identify non-financial risks associated with a certain business or entity. The belief is that if you are able to avoid these types of risks, then you can avoid negative effects if they ultimately develop into financial risks. While many asset managers have the ability to screen out specific securities and industries based on client restrictions, a much smaller subset incorporates ESG analysis across their investment decisions. Just as there are different types of responsible investments, there are a variety of ESG research methods leveraged within the investment process. The most common methods are as such:

- **Third-party information** usage can be bucketed into several forms, but in all of these cases ESG data and information is collected from outsourced vendors. It is common that some form of third-party information is incorporated into proprietary ESG research. Types of third-party information include:
    - Qualitative company ESG scores are based on off-the-shelf scoring methodologies that weigh the relevant issues within an industry.
    - Raw ESG data can be used to create proprietary ESG models for each company, based on customized methodologies.
    - ESG reports provide in-depth company reports and are typically used to supplement another research method.
- **Centralized primary research** is conducted by a research team at an investment organization that does not directly manage investments. Oftentimes, the ESG research is part of the traditional fundamental assessment of a company, but sometimes it is conducted by a dedicated ESG research team. Central research is a firm-wide resource and the integration of this research is optional for the various investment management teams.
- **Localized primary research** is performed by the same team that directly manages investments and is fully integrated into the investment decisions. Conducting their own ESG research allows portfolio managers to consider ESG risks and opportunities that are relevant to their own investment philosophy. It also affirms that this analysis is applied consistently from company to company, and while relevant ESG factors vary by industry, the framework is invariable. Lastly, since this type of research is closer to the portfolio buy and sell decisions, a deeper understanding of company-specific ESG factors can often be expected.

Responsible Portfolio Construction

Traditionally, values have been the primary driver of investing in ESG portfolios, dictated by religious, political or personal views. In this regard, negative screening has been the preferred approach to affirm securities of companies with undesirable business involvement were excluded from the portfolio. This method can easily be applied to an existing investment strategy by simply limiting the universe of investable securities. This approach also affirms zero tolerance of any unwanted business practices. From this traditional approach of negative screening came positive screening on ESG metrics. This approach targets companies that feature the most positive ESG characteristics or those that are taking steps to improve their ESG profile. Screening that seeks the most positive ESG company on a relative basis can refer to a broad peer comparison or on a sector-, industry-, regional- or country-relative basis.

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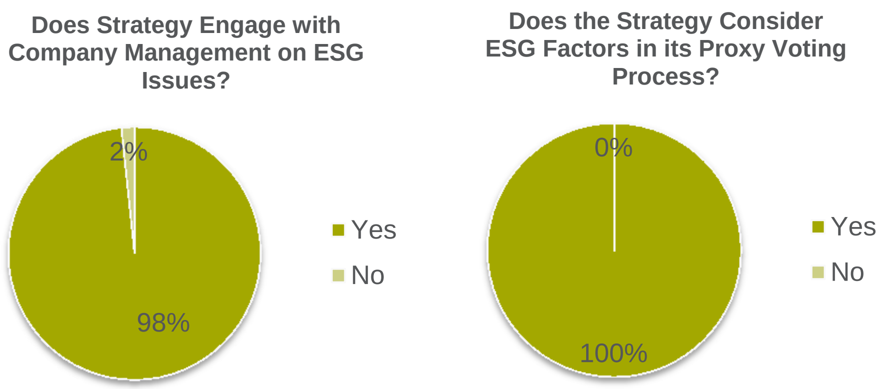
Positive screening can be complemented with negative screening to affirm the ESG integrity of a portfolio is not compromised. Similarly, “tilting” the portfolio, or overweighting positive ESG scoring securities while underweighting negative ESG scoring securities, can be applied in a systematic or qualitative way to build a portfolio based on ESG considerations.

Influencing Issuers

While finding a security to purchase is only part of the process, an equally critical component is what an asset manager does while they own it. Now with a vested interest in a company's ESG performance, many managers will work with portfolio companies to influence their ESG profile. There are several methods of working with companies to improve ESG characteristics such as voting shareholder proxies, engaging directly with company management, and engaging with competitors to enhance industry standards. The level of activism can range from voting proxies only when significant issues arise to engaging with company management on a regular basis on potential future issues far out in the horizon.

eVestment Survey of ESG-Focused Investment Managers



Source: eVestment Alliance, as of November 4, 2016.

Viability in a Portfolio

Despite the high correlations to traditional market benchmarks (see table 1), there are a number of questions remaining about how responsible investments should be viewed and used by clients in the context of an asset allocation model.

Given the fact that some parts of the world are lacking in data standardization, it may be difficult to assess ESG characteristics in those less developed regions to be investable by developed market ESG standards. This may lead to investments in non-transparent entities, or can severely limit the investable universe, resulting in unintended investment biases. Similarly, a number of inflation-hedging investment strategies focus heavily on non-renewable natural resources, which may not be acceptable to an ESG investor. Environmental issues for these commodity producers are also paramount concerns for an ESG investor. To circumvent these issues, asset managers in the space may choose to focus on those natural resource companies that have best in class in ESG characteristics. Alternatively, the allocation can be shifted to include only renewable natural resources.

How to benchmark an ESG-focused manager is an important consideration, given that sector and regional positioning may vary drastically compared to traditional market benchmarks. It is important to recognize that responsible investment strategies may come with significant tracking error when compared to traditional investing, as this approach will generally lead to larger active bets. However, responsible investment strategies in aggregate have demonstrated lower index-relative beta and less absolute risk, as measured by standard deviation of returns and maximum drawdown[1].

Additionally, ESG and SRI equity indices, as proxies for investable portfolios, have mostly demonstrated outperformance relative to their traditional counterparts with less volatility over recent periods (see table 1). One may say that the ability to qualify non-financial risks may significantly lower the investment risk profile of a portfolio, which would explain this phenomenon.

Table 1 – ESG Index Risk/Return Statistics

	Return	Std Dev	Alpha	Beta	Tracking Error	Sharpe Ratio	Information Ratio	Max Drawdown
US Equity Indices - Last 5 Years								
MSCI KLD 400 Social[2]	11.81%	12.05%	0.56%	0.95	1.95%	0.97	0.08	-13.25%
MSCI USA ESG IMI[3]	10.91%	12.47%	-0.59%	0.99	1.43%	0.87	-0.52	-14.74%
MSCI USA IMI	*11.65%*	*12.57%*	*0.00%*	*1.00*	*0.00%*	*0.92*	*0.00*	*-15.20%*
Global Equity Indices - Last 5 Years								
MSCI ACWI SRI[2]	6.23%	12.89%	0.50%	0.95	1.63%	0.48	0.17	-15.42%
MSCI ACWI ESG[3]	6.71%	13.07%	0.88%	0.96	1.10%	0.51	0.68	-15.98%
MSCI ACWI	*5.95%*	*13.54%*	*0.00%*	*1.00*	*0.00%*	*0.43*	*0.00*	*-17.33%*

Gross of fees. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

Responsible Investment Selection

With such a broad spectrum of responsible investment options, asset owners can be overwhelmed or simply confused by the number of choices in the marketplace. While each asset manager has their own approach to responsible investing, each asset owner

[1] Analyses performed in eVestment comparing the standard asset class universes to their ESG equivalents.

[2] MSCI Global SRI Indexes: These benchmarks consist of companies with the highest ESG ratings making up 25% of the adjusted market capitalization in each sector of a parent MSCI index, after excluding companies involved in alcohol, tobacco, gambling, civilian firearms, military weapons, nuclear power, adult entertainment and genetically modified organisms (GMOs). The family also includes the MSCI KLD 400 Social Index, which was launched in May 1990 and is one of the first SRI indexes.

[3] MSCI ESG Focus Indexes: The indexes are designed to target companies with positive environmental, social and governance (ESG) factors while closely representing the risk and return characteristics of the underlying market. Each index is constructed through an optimization process that aims to maximize its exposure to ESG factors, subject to a target tracking error and other constraints. The indexes are sector-diversified and are designed to over-weight companies with high ESG ratings and under-weight companies with low ratings. Tobacco and Controversial Weapons companies are not eligible for inclusion.

has their own intentions when selecting a responsible investment. The foremost step in evaluating appropriate responsible investment strategies is defining its purpose or goal in an overall investment program.

Selection of responsible investments as part of a manager due diligence process presents challenges unto itself, as there are countless additional dimensions that must be evaluated. However, there are some key aspects that we value above others.

It is of paramount importance that the individuals involved with the investment decision making be committed to investing responsibly. While various structures of research and portfolio management teams can operate satisfactorily, it is critical that the portfolio management teams fully consider the ESG aspects of the companies they hold. This minimizes the risk that the portfolio sacrifices its ESG characteristics at a less-than-responsible opportunity to bolster performance.

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From our observations, responsible investment approaches can result in varying levels of success. While qualitative, bottom-up research can provide more targeted responsible investment exposures and a more holistic view on a company, it can be more costly to implement. The use of third-party ESG data can be an effective way to reduce management fees, though may lack details on materiality and directionality. If third-party data is utilized, independent assessment and verification would be prudent.
Due to their market influence and proximity to their portfolio companies, asset managers can improve corporate behavior by actively engaging management and participating in proxy voting. We would highly recommend that managers perform these activities.
Lastly, the usage of responsible investments is an important consideration in the selection process. The type of responsible investment and how it is constructed can introduce sector or style biases, so these must be balanced appropriately at the overall investment plan level.

CONCLUSION

Northern Trust Multi-Manager Solutions maintains a history of involvement in responsible investing, stemming from offering clients with custom investment solutions tailored to their values and growing to providing specific strategies centered around responsibility, sustainability, and positive impact. Today, approximately 35% of our sub-advisors and third party managers are signatories to the United Nations-supported Principles for Responsible Investment (“PRI”) initiative.

We are of the firm belief that investors can benefit from seeking ESG-focused managers and do not need to forego performance to invest well. However, discernment is critical in the manager selection process.

For more information about please contact Multi-Manager_Solutions@ntrs.com

<u>Sources Cited</u>

- B Lab http://www.bcorporation.net/ and http://benefitcorp.net/
- eVestment Investment Manager Database
- Morningstar Direct
- Bloomberg L.P.
- Zephyr StyleAdvisor
- MSCI Indices

IMPORTANT INFORMATION