ESG integration of mainstream Australian Equity Managers

**Study commissioned by
the Australian Council of Super Investors Inc.
and the Investment & Financial Services Association Limited
and prepared by Mercer (Australia) Pty Ltd**

acsi AUSTRALIAN COUNCIL OF SUPER INVESTORS

IFSA Investment & Financial Services Association Ltd

Research Paper

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IFSA is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 145 members who are responsible for investing over $1 trillion on behalf of more than ten million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

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Mercer is the global leader for trusted HR and related financial advice, products and services. Mercer's work with clients makes a positive impact on the world every day and this is done by enhancing the financial and retirement security, health, productivity and employment relationships of the global workforce.

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Executive summary

Over the past few years, increasing recognition has been given to environmental, social and governance (ESG) factors and more investors and funds have started to integrate these factors into their investment processes.[1] While there are studies exploring ESG integration in a global context,[2] there is no study publicly available that investigates how ESG is integrated into investment processes by investment managers of Australian equities. To assess the extent to which Australian managers pursue ESG practices when investing in Australian equities, the Australian Council of Superannuation Investors (ACSI) and the Investment and Financial Services Association (IFSA) engaged Mercer to conduct this study. In particular, this study is designed to:

1. identify the factors that analysts consider to be important in selecting and valuing Australian equities
2. explain the extent to which investment analysts currently incorporate ESG risks and opportunities in their investment decision-making, and
3. identify and explain any factors which may deter investment analysts from considering ESG issues in the process of stock selection.

To explore these themes, Mercer:

- surveyed 135 mainstream Australian equity managers of 443 different active investment strategies in terms of how ESG is integrated into the investment process
- received responses from 51 Australian equity managers of 153 investment strategies
- interviewed 34 managers about ESG integration as well as exploring the major impediments to ESG integration in investment processes.

Conducted between April and May 2009, this research shows that managers are integrating ESG in mainstream Australian equity mandates. In particular:

- Some ESG factors are used to select and value Australian equities
- Some analysts use ESG factors in their proprietary modelling
- ESG factors can be used as an indicator of management quality as well as a buy/sell indicator.

In addition:

- proxy voting and ESG policies are more common amongst survey participants than engagement policies
- ESG was used for risk management and to identify investment opportunities
- external ESG research providers play an important role in supplying ESG information to fund managers,
- however, there was a concern among some fund managers about the quality of some ESG research.

The major impediments to ESG integration include:

- difficulty in quantifying ESG factors
- lack of clear direction from asset owners on ESG requirements
- managers are concerned about the quality of ESG research from external providers and some are therefore reluctant to use this information in their investment modelling processes.

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[1] Ambachtsheer, J. 2008, "We've passed the 'Tipping Point' - 2007 in review and outlook for 2008", available at: http://www.mercer.com/referencecontent.htm?idContent=1291475, accessed 19 May 2009.

[2] For example, see Kennedy, T., Whiteoak, J. and Ye, T. 2008, "A Comprehensive Analysis of the Relationship between ESG and Investment Returns", available at: http://www.ssga.com/library/esps/A_Comp_Analysis_of_Rel_Between_ESG_Todd_Kennedy_11.17.08CCRI1228407230.pdf, accessed 19 May 2009. See also Birgden, H., Guyatt, D. and Jia, X. 2009, "Gaining ground: Integrating environmental, social and governance (ESG) factors into investment processes in emerging markets", available at: http://www.mercer.com/referencecontent.htm?idContent=1210745, accessed 19 May 2009.

ACSI and IFSA plan to review the findings of the research and work together to explore options and meaningful ways to address the key issues raised by this research. Future activities may include:

Promoting ESG integration processes by advising their asset owner members to:

- specify their ESG requirements into superannuation fund Investment Policy Statements and stand-alone policies
- communicate ESG expectations as long-term investors to all incumbent and new managers
- include ESG requirements in Investment Management Agreements
- in all new mandates, specify how ESG issues should be dealt with or considered
- evaluate the capability of incumbent fund managers on ESG by assessing how well ESG factors have been incorporated into investment processes across asset classes
- monitor manager performance on ESG as part of on-going performance reviews
- consider thematic research related to ESG, such as carbon and water.

Assisting asset owners and fund managers to:

- encourage more ESG research activities on Australian equities
- join collaborative initiatives to encourage stronger ESG research flow between brokers, fund managers and asset owners through groups such as the ESG Research Australia (ESG RA)
- promote awareness and further integration by portfolio managers and analysts through industry associations
- review modelling to integrate ESG metrics into stock valuation.

Asset owners and asset managers could also consider the benefits of participating in voluntary initiatives and networks such as the:

- United Nations' Principles for Responsible Investment (PRI), which provides a practical framework for integrating ESG into investment processes
- Carbon Disclosure Project (CDP), by writing to their investee companies urging them to participate.[3]
- Global Reporting Initiative (GRI), by urging investee companies to follow GRI's framework to report their sustainability practices.

[3] Mercer 2009, " Mercer report on investor's support on carbon disclosure project'

Methodology

To help gain an in-depth understanding of ESG practices amongst mainstream Australian equity managers, Mercer surveyed 135 managers covering 443 Australian equity investment strategies, through Mercer's Global Investment Manager Database (GIMD) between April and May 2009. Altogether, 51 managers covering 153 Australian equity strategies responded to Mercer's ESG survey.

The survey contained 22 questions, including both multiple choice and open-ended questions. Questions included a range of items such as whether:

- the fund management firm has an ESG policy
- the fund management firm has a policy on proxy voting
- the fund management firm has a policy on engagement
- ESG is used as a risk management tool and/or used to identify investment opportunities
- ESG is integrated into investment processes
- the fund incentive system encourages long-term investing
- the fund currently provides training on ESG to its investment staff
- the fund has future plans to improve ESG integration.

In addition, 34 face-to-face interviews with Australian equity analysts and portfolio managers were conducted to further explore what current ESG practices were, and what managers consider as impediments to ESG integration. The interviews were conducted by senior Mercer specialist investment consultants who are dedicated Australian equity manager researchers. While most managers interviewed also completed Mercer's survey, a small number of interviewee managers had not answered Mercer's survey.

Overall, the survey and interviews were designed to answer the following questions:

- to what extent ESG issues are featured in investment idea generation as part of the alpha generation process
- to what extent ESG factors are considered as part of the portfolio construction process
- the way the analyst thinks and their beliefs with respect to the relevance of ESG factors in their core process
- how ESG policies are implemented, including the length of the investment horizon and the level of voting and engagement activities.

We also examined other factors such as:

- access to, and utilisation of research that might inform the investment team about ESG issues
- commitment to training and educating investment staff on how ESG issues might impact on the alpha generation process or on value destruction
- implementation and reporting of voting and integration of ESG into the conversations they have with management of corporations
- future plans for improving internal processes to better integrate ESG factors into their investment and active ownership practices.

Section 1: Introduction

The Australian Council of Super Investors (ACSI) provides independent research and advice to superannuation funds on the environmental, social and corporate governance risks of companies in which they invest. ACSI members currently represent more than $250 billion in funds under management and 57% of the Australian not for profit superannuation sector.

ACSI plays a key role in promoting the incorporation of environmental, social and governance (ESG) risk management, ESG reporting and sustainable value creation into superannuation funds', listed companies' and fund managers' processes.

The Investment and Financial Services Association Limited (IFSA), is a not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 145 members who are responsible for investing over $1 trillion on behalf of more than ten million Australians.

IFSA's mission is to play a significant role in the development of the social, economic and regulatory framework in which its members operate, thereby assisting members to serve their customers better.

To understand how investment analysts currently incorporate ESG risks and opportunities into their investment decision-making, and to identify impediments that might inhibit investment analysts from examining ESG issues, ACSI and IFSA has commissioned Mercer to conduct this study.

The report is structured as follows: section 2 discusses ESG integration at firm level; section 3 covers ESG integration at strategy level, including identifying key factors that analysts consider to be important in selecting and valuing Australian equities, and how ESG factors could be integrated into the valuation process; section 4 explores impediments to ESG integration; and section 5 provides a conclusion and an outline of possible future activities to address the findings of the research.

Section 2: ESG integration at firm level

At firm level, managers are integrating ESG in mainstream Australian equity mandates. The research indicated that:

- Proxy voting and ESG policies are more common among survey participants than engagement policies
- External ESG research providers play an important role in supplying ESG information to fund managers
- There was a concern among some fund managers about the quality of some ESG research.

2.1 Profile of survey participants

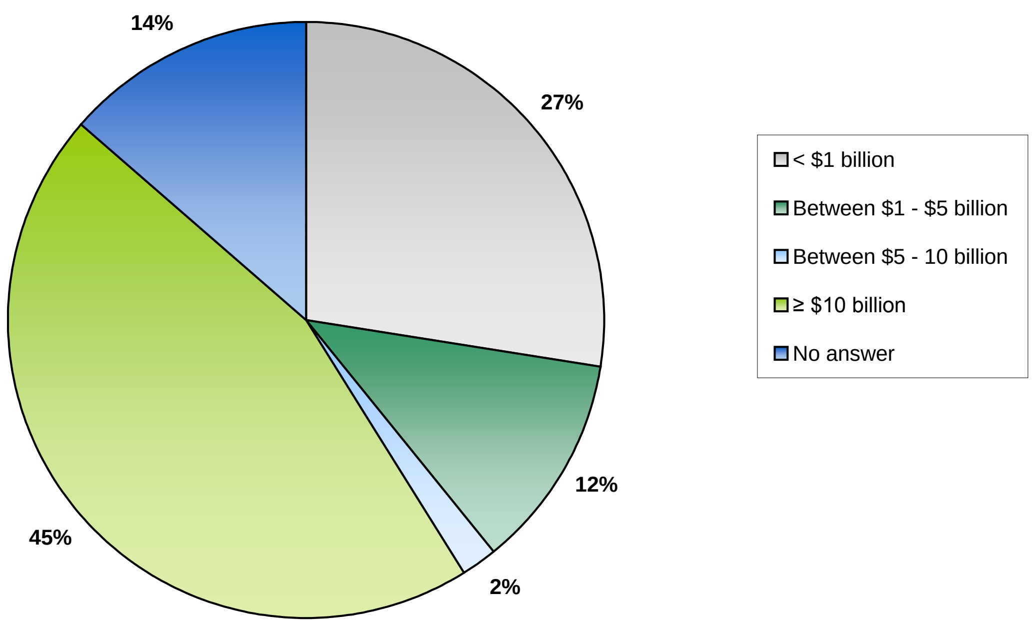
Investment managers that participated in Mercer's survey can be categorised into the following:

1. Less than AUD1 billion of Funds under Management (FUM)
2. AUD1-5 billion FUM
3. AUD5-10 billion FUM
4. More than AUD10 billion FUM
5. Signatories to the United Nations' Principles for Responsible Investment (PRI)
6. Non-signatories to the PRI
7. Style: Value, Growth, Style Neutral, etc

The following three figures show the key characteristics of fund managers who participated in the research and their responses at firm level:

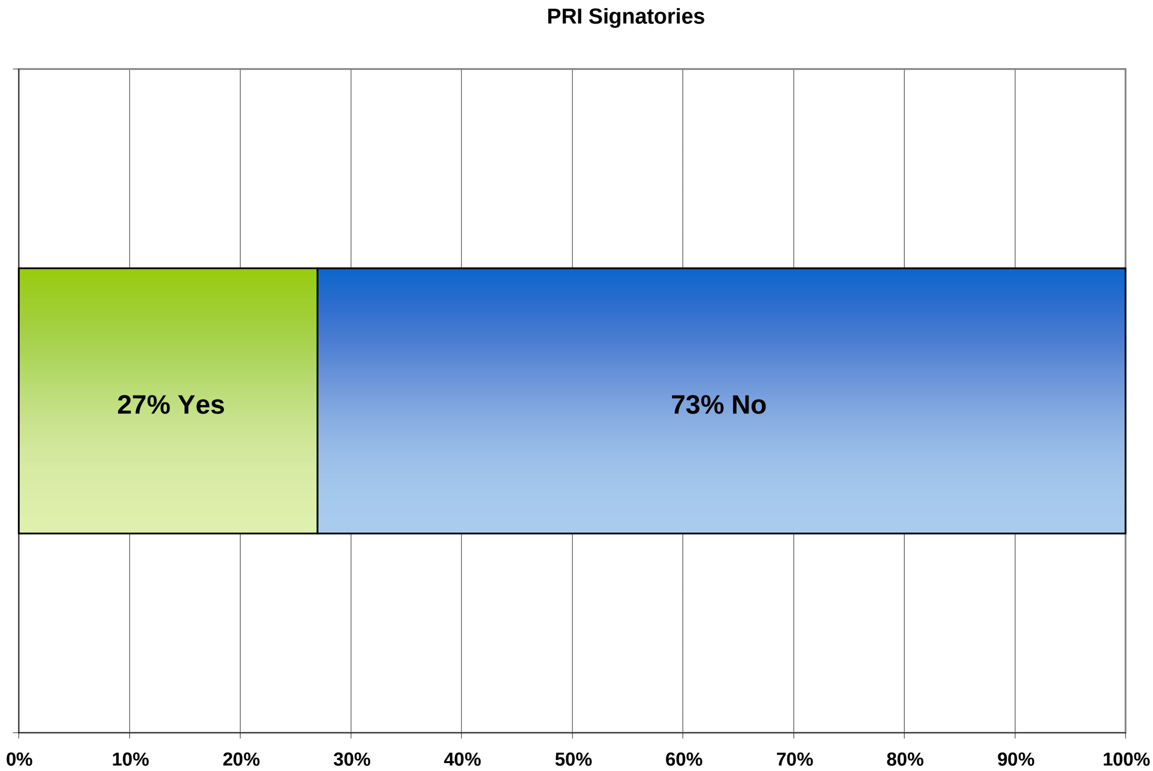
Figure 1

Funds Under Management of 51 Managers surveyed



In terms of mandate sizes, about 45% of the managers surveyed have Funds Under Management (FUM) of more than AUD$10 billion and 27% have FUM less than AUD$1 billion.

Figure 2

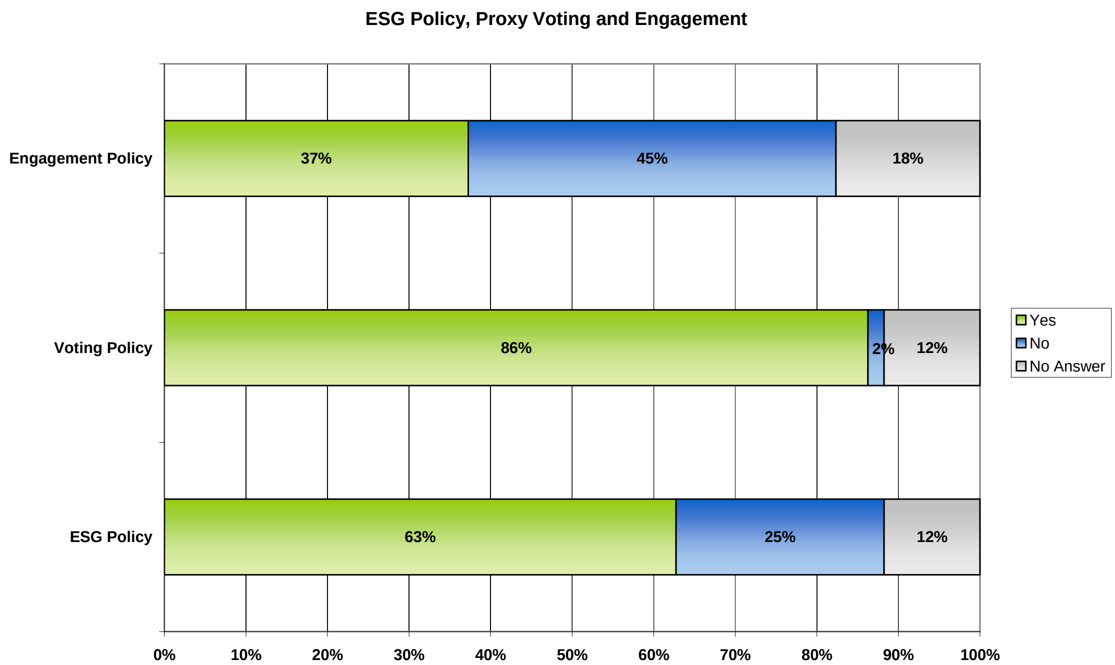


About 27% of managers surveyed are PRI signatories and in contrast 73% of managers surveyed are non-PRI signatories.

2.2 ESG, proxy voting and engagement policies and practices

The following figure summarises whether investment managers surveyed have an ESG, proxy voting and engagement policy.

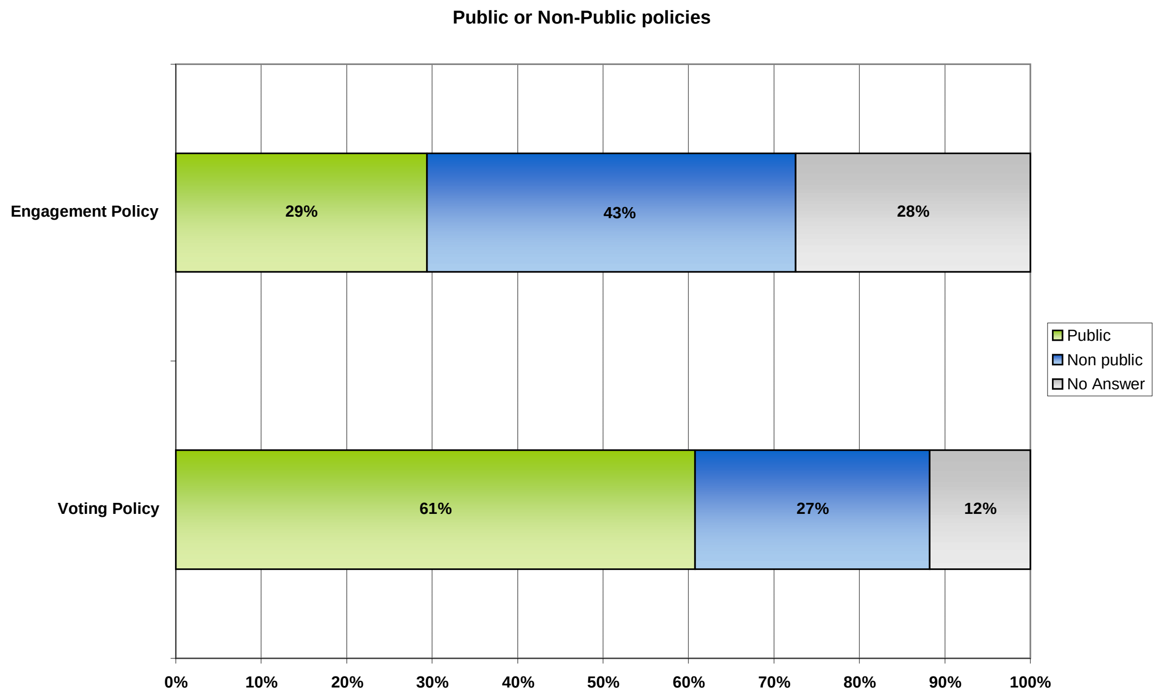
Figure 3



As shown in the figure on the previous page, about 86% of survey participants have a voting policy, around 63% have an ESG policy; this compares with only 37% of participants who have an engagement policy. This suggests that some managers have not yet taken the step to engage with companies beyond proxy voting. Some managers noted that they would rather divest than engage with companies if the issues are material and therefore likely to impinge on investment value.

For those who have an engagement policy and/or a voting policy, Mercer asked them to indicate whether their policy is public or not.

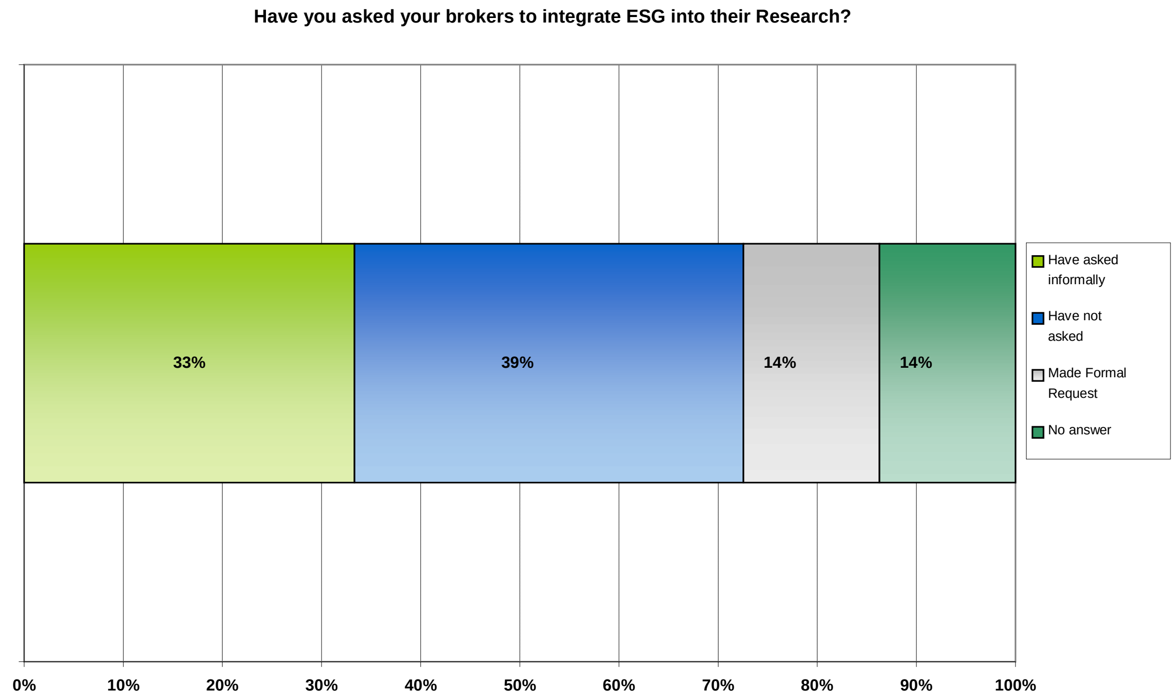
Figure 4



It is common for survey participants to make public their proxy voting policy (61%) rather than their engagement policy (29%).

Quite a few managers believe that ESG issues are important but feel that currently there is lack of research - as noted by one manager, *"ESG issues are under researched, yet the issues are important sources of business risks and opportunities. Hence, we believe that by holistically integrating these issues into our research processes, we can generate excess returns for clients".*

Figure 5



Around 13% of managers surveyed have informally asked their brokers to provide ESG integrated research, and a further 33% asked for ESG integrated research information; this compares to 39% of managers who have not sought ESG integrated research at all.

A few managers commented that the quality of broker research needs to be improved, and as stated by one manager, “we encourage ESG research from brokers via commission tagging and via a meaningful weighting to ESG research in the regular Broker Panel Review. This is designed to encourage ESG research as part of the mainstream broker services. We are willing to review and improve this commitment to ensure that increased quality analysis is appropriately funded”.

Section 3: ESG integration at strategy level

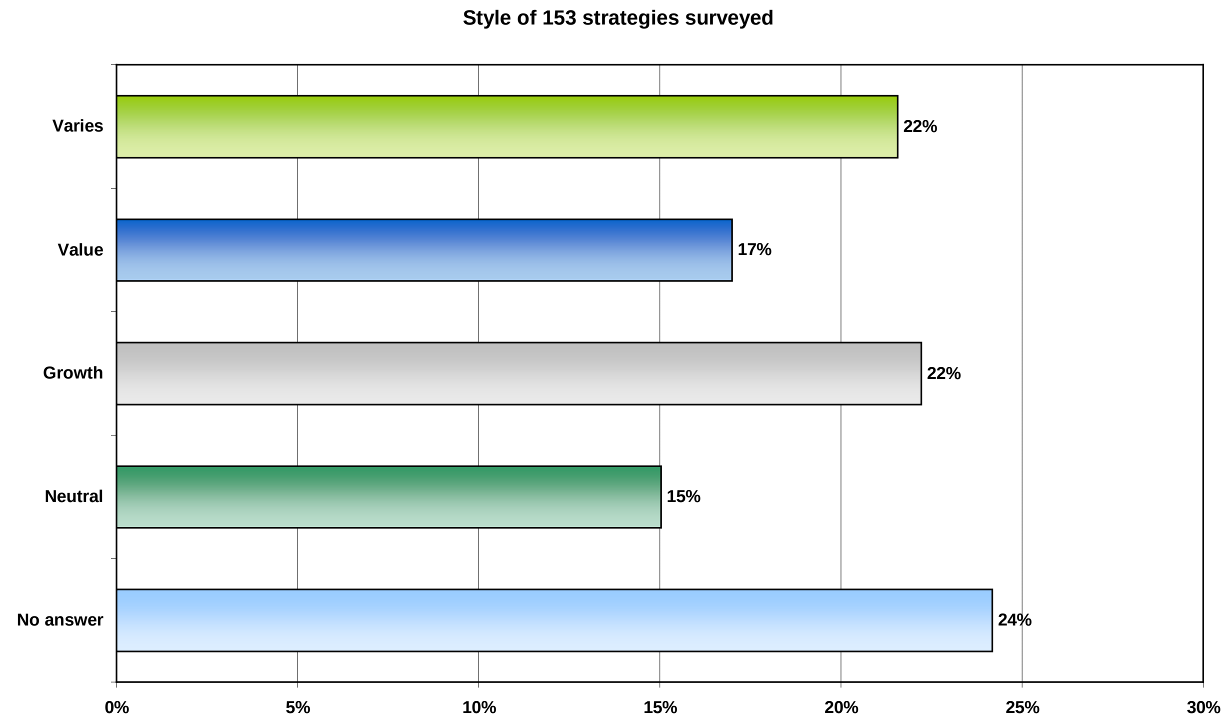
At the strategy level, the research found that:

- ESG was used by some fund managers for risk management and to identify investment opportunities
- external ESG research providers play an important role in supplying ESG information to some fund managers
- ESG is mostly thought of as a qualitative input into assessing the quality of management, rather than a buy/sell indicator driving short-term alpha.

3.1 Investment style of strategies surveyed

Investment style of strategies surveyed is illustrated in the following figure.

Figure 6



In terms of investment style, around 15% of the strategies surveyed are Style Neutral, about 22% are Growth, approximately 17% are Value and the remaining 22% of the managers surveyed said their investment style is not captured by the above categories and can move stylistically.

3.2 Important factors for selecting and valuing stocks

In order for an active manager to be successful in generating excess returns, the valuation process must be successful in identifying investment opportunities that are mispriced by the market or in indicating a trend. The amount by which a company is mispriced becomes part of the total expected return by the manager over the holding period.

In attempting to ascertain the extent to which a company is mispriced, fundamental or research-driven investment processes consider a range of qualitative and quantitative factors.

Attributes such as management quality and track record, industry growth rate, industry structure, company-specific growth rate and company valuation relative to the market are central to the qualitative assessment.

In addition to an understanding of the industry in which a company operates, an assessment of the quality of management is considered to be central to the decision to invest in a company.

This qualitative analysis is typically complemented by a range of quantitative valuation approaches. The appropriateness of any specific valuation approach can be influenced by the industry in which the company operates. Regardless of which valuation methodology is used (Price to earnings, absolute and relative to industry or market, discounted cash flow (1, 2 or 3 stage), Enterprise Value to earnings before interest and tax, Dividend Discount Model, Earnings Yield, Internal rate of return, Cash Flow Return on Investment, Economic Value: Market Value, Price: EBITDA), key assumptions on revenue and margins are developed in order to generate earnings per share, cash flow and balance sheet forecasts. The comparison of valuations across industries or regions, and relative to historical ranges, can provide insight into future share price movements.

In addition, many fund managers will utilise top-down themes to apply an industry tilt to their portfolio. The most common would be macro-economic analysis, to tilt between sectors based on their exposure to changing economic factors. Other themes include globalisation, technology, demographics and longevity, and environmental. These longer term factors tend to have small short-term impacts but may yield longer term enhancements – as such, managers tend to control these themes from a top-down risk factor perspective, without allowing them to dominate stock selection decisions.

How ESG is integrated

How can ESG be integrated into stock selection and valuation processes? Some managers described how their research approaches could take ESG into account. One manager suggested that ESG adds value to their investment processes by describing how ESG factors affect the valuation of their investee companies, and how they incorporate ESG into their fundamental research from a bottom-up perspective. Another manager indicated that ESG was part of the process for formulating a view on the sustainability of a company and its business model, as the following statement indicates:

> *"the examination of non-financial information can yield insights vital in assessing long-term sustainable valuations, thus allowing the best investment decisions to be made. Issue such as non-transparent boards, related party transactions and occupational health and safety failures are often symptomatic of sub-standard management, ultimately leading to underperformance or value destruction".*

Use of proprietary ESG modelling

Some managers are using different proprietary models to capture ESG factors in their investment processes. For example, one manager employs an ESG rating overlay as an input to the stock selection process. Another manager employs a research process which evaluates ESG factors using a system of positive, negative and neutral indicators for valuing stocks.

In order to use ESG factors to help with determining the long-term competitive strength of a company, one manager includes ESG factors as a qualitative score in their positive investment screening model. Another manager employs ESG factors in a more quantifiable way, as the following statement reveals:

> *"ESG issues are considered for materiality and incorporated into valuations where relevant. For example, environmental sustainability issues are often considered based on their potential to a company's earnings (e.g. cost of carbon emissions). Risk associated with corporate governance issues is often taken into account in valuation through the multiple applied to earnings or through a discount rate in a Discount Cash Flow (DCF) valuation".*

Another manager believes that ESG factors need to be analysed and rated, as these factors form the core of the fundamental risks which quantitative modelling can overlook. To take these issues into account, this manager "directly incorporates a number of governance factors into the investment process using proprietary data to rate firms based on their board structure, director independence, audit process, remuneration policies and a number of other factors", as "these governance signals have performed strongly during recent difficult market conditions". Some managers who focused their analysis mainly on governance issues believe that this will help improve investment return and the investment industry in general.

ESG as an indicator of management quality

A few managers believe that a company's ESG practices serve as a proxy for assessing the quality of management, and stated *"a company's rating on sustainability issues is an excellent proxy and leading indicator for the overall quality of its strategic management and hence for the long term prospects for returns".* One manager thinks that *"ESG issues are a key factor in (the) assessment of the company's quality".*

Other managers choose to consider ESG to minimise downside risk, and noted,

> *"ESG issues are considered when making an investment decision when investment returns are adversely affected due to poor standards or activities considered environmentally, socially or ethically unacceptable".*

Another manager believes both financial issues and non-financial issues are important noting that:

> *"…(our) responsibility to investors includes protecting the interests of our clients from the impacts of financial and non-financial risks. To this end, engagement on non-financial issues is essential in maintaining and increasing the understanding of these risks. The idea that good quality companies operating at an environmentally and socially sustainable level are more likely to survive and deliver long-term shareholder value suggests that an analysis and understanding of the non-financial criteria should actually offer additional assistance in identifying long-term winners".*

ESG as a buy/sell indicator

The research found that ESG factors are sometimes used as a filter for buy/sell decisions. While the research showed that some analysts and portfolio managers are not convinced that superior ESG performance of a company will lead to short-term alpha, poor ESG performance could make the company unattractive as an investment target at any valuation, as the downside risk is high. One manager noted that ESG factors act as a stop/go filter where:

> *"the analysis process requires the analyst to make a statement about the ESG culture of the company. If the company fails this test, it is excluded from the portfolio".*

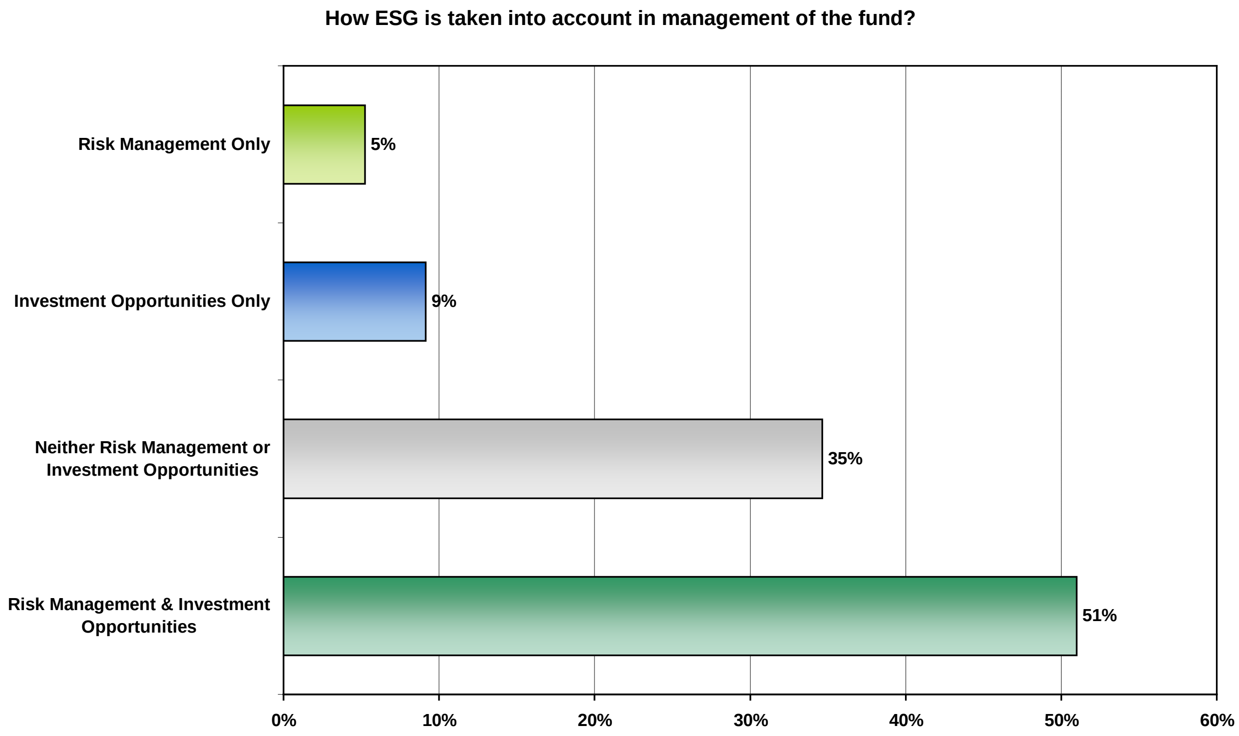
In addition, a few managers use ESG factors to identify sector-specific opportunities, for example, they conduct top-down analysis on climate change issues and review opportunities on thematic investment opportunities such as clean energy and cleantech.

Finally, there are also a few managers who think ESG is important and have included a specific section on ESG on their stock recommendation reports, but still find it hard to incorporate ESG fully into the stock selection process.

3.3 Use ESG factors as a tool to enhance risk management and identify investment opportunities

According to our survey and interviews, ESG analysis was used as a tool to enhance risk management as well as to identify potential alpha-generating investment opportunities.

Figure 7



Around half of the managers surveyed indicated that they use ESG analysis both as a risk management tool as well as a tool to identify investment opportunities. Just over a third responded that they did not take ESG into account for either risk management or investment opportunity purposes.

Some of the managers stated that ESG was used as a tool only to identify opportunities; as expressed by an investment manager in the survey:

> *"Investment performance is increasingly subject to changing environmental forces, social trends and governance imperatives (ESG). ESG risks can be defined as issues, events or trends that not only have the potential to damage a company's current value but also limit its longer-term growth potential".*

Only 5% of respondents used ESG analysis as a risk management tool. As noted by one manager, "ESG risks have the potential to destabilise stakeholder relationships while ESG opportunities may align or balance stakeholder interests". Another manager also expressed that being a signatory to the PRI, "has strengthened (our) commitment to progressively incorporating ESG issues into our investment decision and ownership practices".

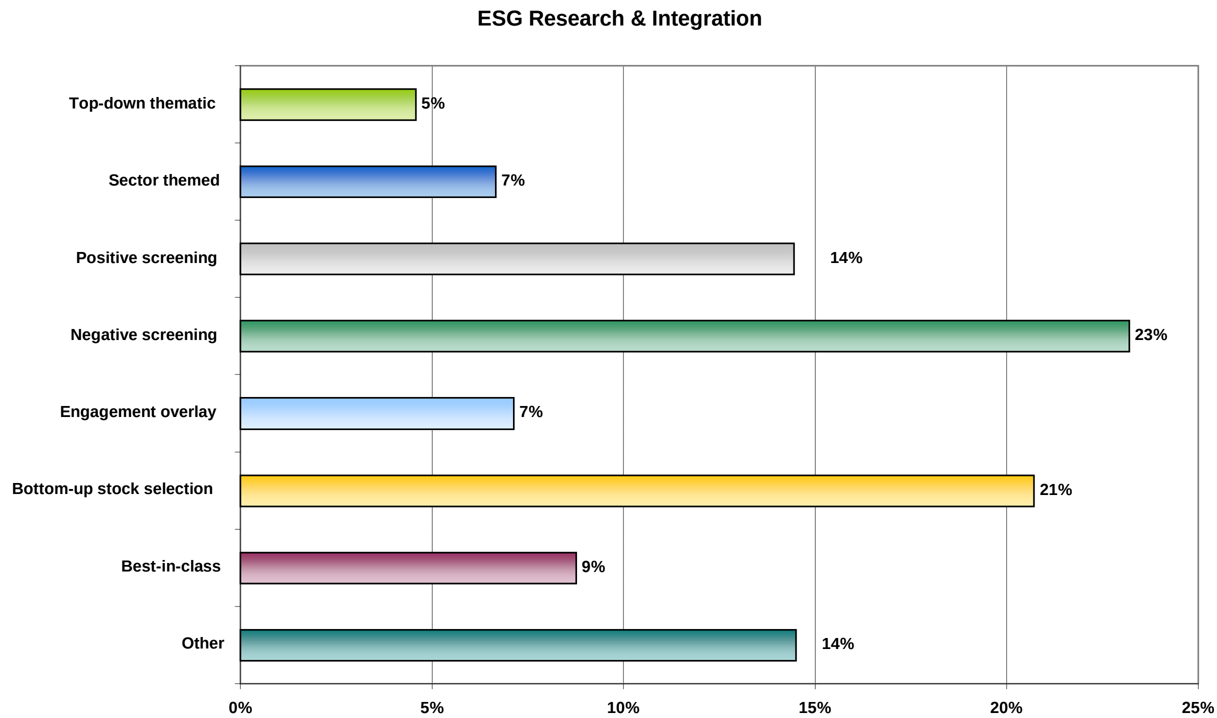
3.4 ESG research from external research providers

A number of managers surveyed also stated that they have access to proprietary ESG research provided by external research providers other than brokers. Others also stated that their ESG information is mainly gained from engaging with companies.

An overview of external ESG research providers is set out in Appendix 1.

The following figure shows how ESG information is used by those managers who were surveyed and interviewed in Australian equity investing.

Figure 8



According to our survey, the three most popular methods for using ESG are for negative screening, positive screening and in bottom-up stock selection.

A brief explanation of each approach is listed below[4]

Best in class

Investment in companies that are considered to be superior to their peers within a particular industry or sector on measures of environmental, social and corporate governance issues. This typically combines thematic issues and consideration of how they impact on sectors and companies within relevant sectors.

Bottom-up integration of ESG into valuation metrics

The bottom up integration of ESG means that these issues are taken into account in the assessment of a company's prospects and long-term valuations. It will influence the extent to which a company is over/underweight versus the portfolio's benchmark and will feed into the way the portfolio manager identifies risks and opportunities.

Engagement Overlay Service

A third-party service that engages investee companies on behalf of shareholder clients. Currently offered by a small number of investment managers and independent service providers.

Negative screening

An investment approach that excludes some companies, sectors and sometimes countries, from the investment universe based on criteria relating to their policies, actions, products or services. Investments that do not meet the minimum standards of the screen are not included in the investment portfolio. Criteria may include environmental, social, corporate governance or ethical issues. Common negative screens exclude investments in tobacco, alcohol and weapons manufacturers.

Other negative screens aim to exclude companies that are considered poor executers in the areas of environmental and social management or corporate governance.

Positive screening

Portfolios are tilted towards stocks that rate well on the nominated ESG criteria. The criteria could include environmental, social, corporate governance or ethical issues. Common positive screens include measures of energy efficiency, corporate governance standards, environmental management or employment standards. Increasingly, these factors are deemed desirable attributes for financial and non-financial measures.

Sector-themed

An investment approach that identifies broad top-level ESG related themes at the market level and translates these into views on the likely impact at the sector level. An example might be to consider the sectors that will expand and contract due to new and changing corporate practices in the shift to a lower carbon economy.

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[4] For further information refer to: Mercer 2007, "The language of responsible investment: an industry guide to key terms and organisations', available at: http://www.mercer.com/ridictionary, accessed 14 May 2009.

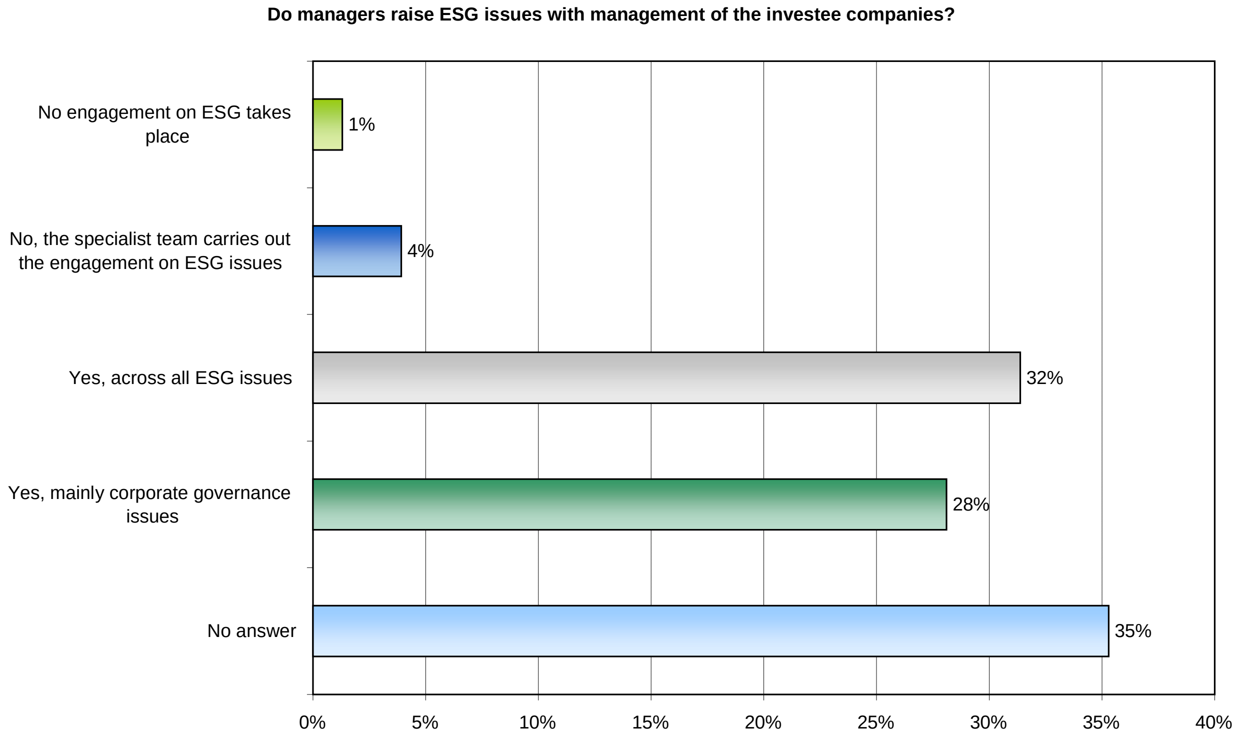
Top-down thematic

High level ESG issues identified at the strategic level that may impact on portfolio performance, where the issues change over time in response to new developments in the investment environment. A current example might be the 'pay for failure' issue amongst corporate executives and fund managers' assessment of how different companies are responding to stakeholder pressure on this issue.

3.5 Engagement with investee companies

To further explore participants' engagement practices, we asked them whether they raise ESG issues with the management of their investee companies.

Figure 9



Around a of third managers (32%) raise ESG issues with their investee companies, and less than a third of managers (28%) raise corporate governance issues. More than a third of survey participants (35%) did not answer this question.

Some managers believe that ESG factors have been incorporated into their investment processes via corporate governance especially through proxy voting. For example, a few managers have adopted a company-wide policy to vote on all resolutions.

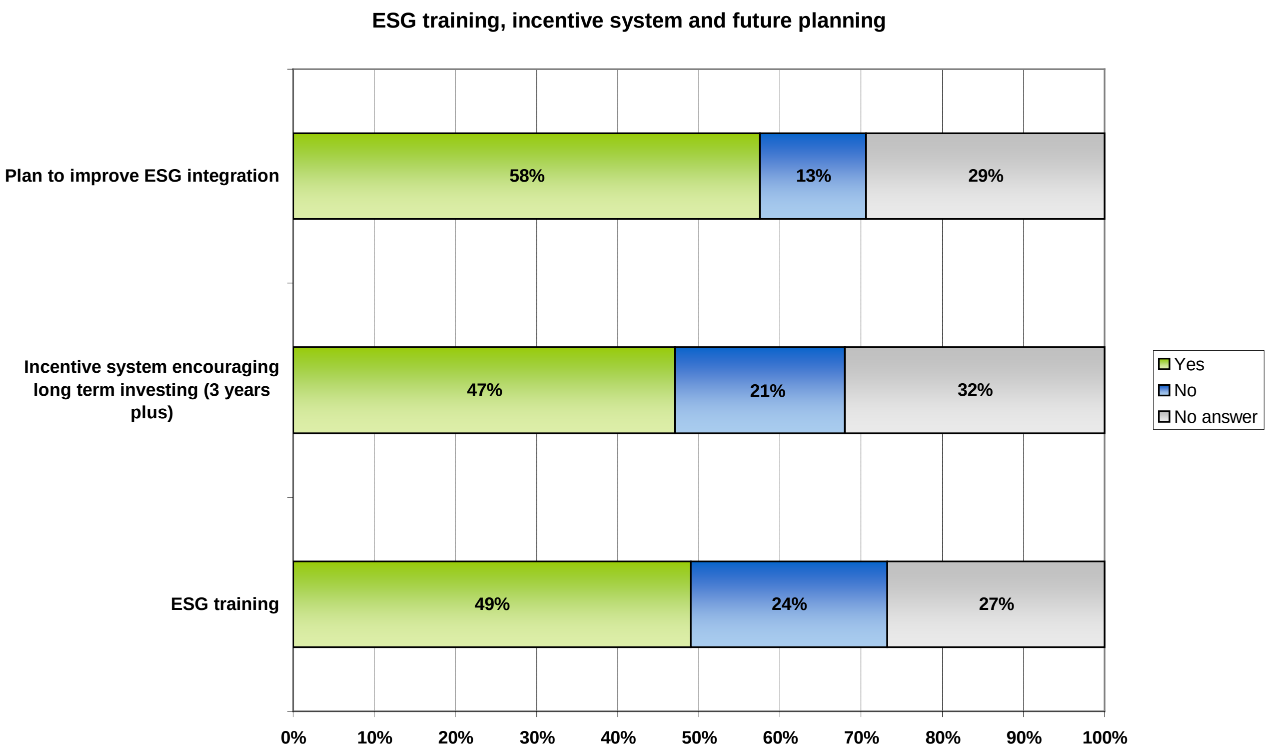
A few managers stated that if investee companies have negative ESG characteristics, they may choose to sell the company's stocks rather than try to engage.

3.6 ESG training and long-term investing

Given the growing interest in ESG factors and long-term investing, and how investment management firms promote more ESG understanding through training, we surveyed participants on the following:

- whether managers have conducted any training on ESG for their investment team,
- whether their incentive system encourages a long-term horizon (defined as 3+ years in our survey), and
- whether the investment team plans to make any changes to improve their ability to integrate ESG.

Figure 10



As shown in the above figure, about 57% of managers are planning to make changes to improve ESG integration in the future; roughly 47% of managers think that their incentive system encourages long-term investing and ESG integration, and around 49% of managers already provide training on ESG to their investment team.

Some of the investment managers explained in the survey how their incentive system is designed to encourage long-term investing. For example, one manager stated that their incentive system remunerates investment out-performance over rolling 5 year periods. Other managers provided more insights on how their compensation related to ESG and responsible investment; as stated by one manager, “valuation of ESG issues can play a role in shaping the future value creation and growth of a company. As such, they may be incorporated into the long-range financial models developed by our research analysts. The analysis conducted by our analysts yields investment recommendations whose performance is closely monitored in determining the compensation of our research staff”.

Another manager also explained that their performance management system is based on a balanced scorecard and responsible investing has been made part of the balanced scorecard system. From the company’s CEO down, performance on responsible investment indicators forms part of the key performance indicators for relevant staff.

Section 4: Impediments to ESG integration

Despite the positive results of the survey and interviews on the integration of ESG into investment decisions,[5] the research also identified impediments to ESG integration:

- ESG factors are hard to quantify;
- Managers stated they lacked clear direction from asset owners on ESG requirements; and
- Managers are concerned about the quality of ESG research from external providers, and some are therefore reluctant to use this information in their investment modelling processes.

Hard to quantify the ESG factors

A few managers stated that they have not developed a systematic method for weighting ESG factors. Some managers also stated that they feel ESG factors cannot help with predicting future stock price movements or future returns; therefore, they would prefer to use Value and Momentum factors rather than ESG factors. As noted earlier in this report, ESG is often considered to be a qualitative signal and some managers were of a view that it could not be sufficiently incorporated into quantitative modelling in the pursuit of short-term alpha. Another point of view was that quantitative modelling typically overlooked ESG factors as a result. Following on from this theme, some managers felt that this was one reason why they still find it hard to incorporate ESG fully into the stock selection process. Another associated issue described by analysts and portfolio managers was that some managers believe that ESG issues are overly “hot” and “emotive”. Another manager believed that the issues won’t really become investment-related for another 4-5 years, which is a challenge for fund managers when they have a short-term investment horizon.

No clear direction from clients to take this into account and ESG integration needs to be client led

A common response in the survey and interviews from the investment managers was that they will look at ESG if required by the client. One manager said that they will only consider ESG if they have been given a specific mandate to do it. Another stated that they feel that as an asset manager acting on behalf of asset owners, they need to be cautious, and expressed their view as: “(While we) regard ESG issues as important, their importance to an asset manager under its fiduciary is (only) in proportion to their ability to influence security prices. We are not investors as principals, but as agents of our clients, and it is our client’s values or concerns that must be used to drive the criteria against which we judge companies”. This was again emphasised by other managers who believe that it is the “asset owners that need to make a decision to apply ESG, not asset managers, as asset managers are only the agent that helps asset owners trade on their account”.

Concern about the quality of ESG research

A few managers were sceptical about the quality of research provided by external ESG research provided. Frustration with the existing external ESG information providers was expressed by some interviewees. Indeed, some fund managers found that, when they (the manager) investigated ESG issues that companies faced, their understanding was deeper than that provided by ESG specialise researchers. In addition, some managers expressed a concern that ESG inputs are not explicit, but are characterised as common-sense and qualitative.

[5] Refer to Garz, H. and Volk, C. 2007, “What really counts: the materiality of extra-financial factors”.

ESG is only for the good times

Another concern was that ESG exists in a bull market but will become less relevant as times get tough. In other words, will ESG be seen as one of the ‘nice to have’ options in investment management that gets squeezed out by the demands of more visible tasks? One manager also argued that ESG has a negative impact on performance, but stated that he needs better data to evaluate the performance implications. He is keen to observe how ESG factors perform during the bear market, stating that *“if things get difficult, investors won’t give a rats about ESG issues”.*

Section 5: Conclusion and recommendations

In conclusion, the research has identified that ESG is considered by many mainstream managers in their investment processes, but gaps remain. Proxy voting and ESG policies are more common than engagement policies and practice. ESG was used both as a risk management tool as well as a tool to identify investment opportunities. Some managers have developed thoughtful procedures to capture ESG signals in their stock valuation and portfolio construction processes.

Key barriers include the view that ESG information is hard to quantify, particularly over the investment horizon in which they make investment decisions (12-18 months). Some fund managers also claimed that clearer signals from asset owners in regard to their expectations for ESG integration would also be valuable, particularly from PRI signatories. On the research side, some managers indicated that there is a need for more broker research to be provided on ESG as the quality of specialist ESG research providers was not well regarded by some.

While previously there has been an increase on the coverage of extra-financial issues by sell-side research providers[6], the recent financial crisis has seen the scale back of research activities by some sell-side brokers[7]. This suggests that, unless there is a clear message that trickles down from asset owners to fund managers that research on extra-financial issues needs to be an integrated part of the investment process, then the demand from the 'buy-side' is unlikely to be strong enough to encourage the 'sell-side' (brokerage firms) to deliver this research[8].

ACSI and IFSA plan to review the findings of the research and work together to explore options and meaningful ways to address the key issues raised by this research. Future activities may include:

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Promoting ESG integration processes by advising their asset owner members to:

- specify their ESG requirements into superannuation fund Investment Policy Statements and stand-alone policies
- communicate ESG expectations as long-term investors to all incumbent and new managers
- include ESG requirements in Investment Management Agreements
- in all new mandates, specify how ESG issues should be dealt with or considered
- evaluate the capability of incumbent fund managers on ESG by assessing how well ESG factors have been incorporated into investment processes across asset classes
- monitor manager performance on ESG as part of on-going performance reviews
- consider thematic research related to ESG, such as carbon and water.

[6] For a comprehensive review of research coverage, refer to Enhanced Analytics Initiative 2008, "Beyond the low-hanging fruit: December 2007 Evaluation of extra-financial research", available at: http://www.enhanced-analytics.com/portal/Library/Documents/EAI/EVALUATION/fr_LIB03967.pdf, accessed 8 May 2009. See also European Centre for Corporate Engagement 2007, "Use of extra-financial information by research analysts and investment managers", accessed 9 May 2009. add another reference from the SAM reference list…

[7] Responsible Investor 2008, "JP Morgan ends dedicated ESG research coverage", available at: http://www.responsible-investor.com/home/article/jp_morgan/, accessed 8 May 2009.

[8] Ibid.

Section 5: Conclusion and recommendations

Assisting asset owners and fund managers to:

- encourage more ESG research activities on Australian equities
- join collaborative initiatives to encourage stronger ESG research flow between brokers, fund managers and asset owners through groups such as the ESG Research Australia (ESG RA)
- promote awareness and further integration by portfolio managers and analysts through industry associations
- review modelling to integrate ESG metrics into stock valuation.

Asset owners and asset managers could also consider the benefits of participating in voluntary initiatives and networks such as the:

- United Nations' Principles for Responsible Investment (PRI), which provides a practical framework for integrating ESG into investment processes
- Carbon Disclosure Project (CDP), by writing to their investee companies urging them to participate.9
- Global Reporting Initiative (GRI), by urging investee companies to follow GRI's framework to report their sustainability practices.

In addition, to facilitate more research and understanding on ESG issues and integration, ACSI and IFSA intend to hold a forum of fund managers and asset owners to discuss the key findings of this research, and to seek to agree on a way forward.

[9] Mercer 2009, " Mercer report on investor's support on carbon disclosure project'

Appendix A: Overview of major ESG research providers

	Organisation	Web Address	Summary***
1	Carbon Disclosure Project (CDP)	www.cdproject.net	As an independent not-for-profit organisation, Carbon Disclosure Project (CDP) holds the world's largest database of corporate climate change information. The CDP through its Gold standard methodology aims to collect and disseminate high quality climate change information that assists investors, corporations and governments in tackling the adverse effects of climate change.
2	Corporate Monitor	www.corporatemonitor.com.au	Corporate Monitor is an Australian focused body that offers research on responsible investment and corporate sustainability through the analysis of non-financial aspects of activity in both companies and responsible investment funds.
3	CAER**	www.caer.org.au	The Centre for Australian Ethical Research (CAER) is the Australian partner of the EIRIS. Founded in 2000, the CAER offers broad based ESG research with complete coverage of the ASX300 index as well as on client specifically selected companies in Australia and New Zealand.
4	Ethical Investment Research Services (EIRS)	www.eiris.org	EIRIS is a UK based not-for-profit organisation. It provides independent research into the social, environmental and ethical performance of companies. Together with its international research partners EIRIS provides coverage of more than 2,800 companies in Europe, North America and Asia Pacific. EIRIS currently provides research to 60% of ethical funds in the UK, with clients ranging from pension funds to charitable and religious organisations.
5	Glass Lewis & Co.	www.glasslewis.com	Glass Lewis provides research and analysis on more than 16,000 public companies based in 65 countries. The organisation assists clients with investments in public companies by minimising exposure to those that have inherent investment, financial or reputational risk. Major services provided by Glass Lewis include proxy advisory and voting services and class action settlement solutions etc.
6	GovernanceMetrics International (GMI)	www.gmiratings.com	GMI offers clients a subscription based corporate governance monitoring tool. The tool provides independent analysis of governance characteristics of more than 4200 companies that make up the MSCI World and EAFE indexes.
7	Innovest	www.innovestgroup.com	Innovest Strategic Value Advisors seeks to better integrate sustainability and finance by identifying non-traditional sources of risk and value potential for investors. The analysis of 120 factors outside traditional fundamental security analysis is conducted with a view to aid clients in constructing portfolios that outperform the market. Innovest currently has $1.3 billion under advice with clients in the asset management and pension funds space.

Appendix A: Overview of major ESG research providers

	Organisation	Web Address	Summary***
8	Integrative Strategies (IS)	www.isforum.org	The Integrative Strategies (IS) Forum is a US based non-profit organisation that promotes and identifies ESG integration locally and globally.
9	KLD	www.kld.com	Founded in 1988, KLD is an independent investment research firm providing management tools to professionals integrating ESG factors into their investment decisions. KLD offers a broad product base; research, indexes (performance benchmarks) and consulting services. Currently, KLD works with more than 30 of the world's top 50 institutional money managers.
10	Monash Sustainability Enterprises (MSE)	http://arts.monash.edu.au/ges/mse/index.php	Monash Sustainability Enterprises (MSE) is the consulting, advocacy, and training arm of the Monash Centre for Environmental Management. MSE is one of the key players in integrating ESG factors into the corporate practices of Australian financial institutions.
11	Regnan Governance Research and Engagement	www.regnan.com.au	Regnan provides ESG data on S&P/ASX200 companies via its ValDA™ platform. With a focus on both quantitative and fundamental analysis, the data integrates into client's investment processes as they seek to meet their investment performance and comply with responsible investment principles under the PRI.
12	RiskMetrics*	www.riskmetrics.com	RiskMetrics aims to augment financial markets by leading initiatives to ensure transparency, expertise and access to all market participants. With core capabilities in financial risk management, RiskMetrics examines risks surrounding corporate governance, compliance, accounting, legal, transactional and sustainability.
13	Sustainable Investment Research Institute (SIRIS)	www.siris.com.au	The Sustainable Investment Research Institute (SIRIS) offers ESG with a focus on the Asia Pacific Region. SIRIS research offers analysis of the traditional ESG factors augmenting this with critical aspects of operational and brand risk and other emergent investment themes and opportunities.
14	Trucost	www.trucost.com	Founded in 2000, Trucost is an independent environmental research provider that helps investors and companies better understand the impacts of environmental risks. Trucost provides clients with company emissions and natural resource usage data on over 4,500 global companies, with coverage of majority of the developed world's investment universe.

* Includes International Shareholder Services (ISS), now a part of RiskMetrics
** From the Centre for Australian Ethical Research (CAER)
*** From each company's website

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