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Responsible Investor/MSCI ESG Research Round Table Report 2014

ESG inside: practical integration into the investment process

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MSCI ESG Research products and services provide in-depth research, ratings and analysis of environmental, social and governance-related business practices to clients worldwide. ESG ratings, data and analysis from MSCI ESG Research are also used in the construction of the MSCI ESG Indexes. The MSCI ESG Research team consists of more than 160 specialists worldwide, including more than 100 dedicated ESG analysts and researchers.

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MSCI ESG Research products and services are designed to provide in-depth research, ratings and analysis of environmental, social and governance-related business practices to companies worldwide. ESG ratings, data and analysis from MSCI ESG Research are also used in the construction of the MSCI ESG Indexes. MSCI ESG Research is produced by MSCI's indirect wholly-owned subsidiary MSCI ESG Research Inc., a Registered Investment Adviser under the Investment Advisers Act of 1940.

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The RI Insight/MSCI ESG Research Round Table Report 2014 brings together a group of respected professionals in ESG research, institutional consultancy and portfolio management to examine the real-world applications for ESG research in the risk/return decisions made by investment managers. The issue of how sustainability-themed data can apply to investment strategy, risk management and stock selection and monitoring is one of the most important in responsible investment. It gets to the heart of issues like ESG materiality, terminology, structural and psychological resistance to ESG in mainstream investing, as well as the limitations of ESG in changing the current institutional investment landscape.
It also points to how responsible investment might position itself to elicit more long-term consideration of sustainability within asset management.

We think it's a fascinating and insightful discussion.

Topics discussed in the RI Insight/MSCI ESG Research Round Table Report 2014 include:

- Should ESG information be considered as a risk or return driver?
- Identifying ESG themes that are relevant to investment risk.
- How could/should asset managers be using ESG data?
- Smart beta and sustainability.
- Putting ESG into the portfolio optimisation process.
- ESG: a terminology problem?
- Investment management resources….and patience for ESG reporting.
- How much are asset owners really asking their investment managers to do, and what is realistic to demand?
- Tracking ESG data over time.
- Using sustainability context for smart investment decisions.

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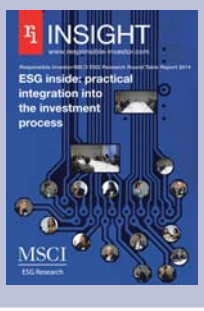

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Moderator:
Hugh Wheelan
Managing Editor
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Introduction

Hugh Wheelan: I'd like to go around the table first so all our panelists can introduce themselves.

Hewson Baltzell: I'm head of development here at MSCI ESG Research. I'm particularly interested in integration. It's our focus in a number of ways. We're constantly looking at more platforms on which to get our data out for the purpose of integration. We have a number of product platforms internally here at MSCI, and we also operate via third-party platforms. Getting the data to where we can connect to investment models, portfolio manager decisions, etc., is all part of how we look at integration.

Sarah Cleveland: I have a long track record in the institutional investment world, having been at Towers Watson and Rogerscasey, and active in the sustainable investment field since about 2003. Now, I'm working on special projects that relate to institutional investors and sustainable investment. I've been working with Ceres on a project, as well as a variety of other institutional investors.

Martin Grosskopf. I'm a portfolio manager with AGF. I used to be with Acuity, which was a partner-based company that we sold to AGF, which is one of the oldest, longest-standing independent companies in Canada with about $38 billion under management. I've been managing an environmental thematic fund and an SRI family fund since 2000. The environmental fund has been around since 1991. It's one of the oldest globally.

Bruce Kahn: I'm a portfolio manager at Sustainable Insight Capital Management. We're a new firm in this space, launched in 2013. Many of us come from previous incarnations at various larger financial institutions such as Deutsche Bank, Morgan Stanley and Citigroup. We have a focus on integrating ESG factors into our portfolio management.

Linda-Eling Lee: I'm the head of ESG research for MSCI ESG Research. We have one of the largest teams in the ESG field of approximately 90 analysts in 14 different offices around the world.

Mary Jane McQuillen: I'm with ClearBridge Investments, where I head up our environmental, social, and governance (ESG) investment program and co-manage our 8 ESG active equity strategies. ClearBridge and its predecessor firms have a history of integrating ESG factors into our fundamental analysis and portfolio stock selection.

Julie Moret: I'm a director in the performance analysis and investment risk group at Franklin Templeton Investments, where I focus on ESG integration. I am responsible for leading Franklin Templeton Investments efforts to further integrate ESG considerations into the investment lifecycle. This means working alongside our analysts, fund managers and the broader investment risk team to introduce ESG into the investment risk framework. I'm based out of London.

Rob Wilson. I work at MFS Investment Management (MFS) on ESG integration. Currently, my job is primarily focused on helping the entire analyst group at MFS to better understand ESG issues and incorporate them into their investment process. We don't have any stand-alone products in the socially responsible investing (SRI) space at this time.

Bracebridge Young: I'm the CEO of Mariner Investment Group, an alternative asset management company, predominately focused on long/short fixed income.

Hugh Wheelan: I'm going to kick off the discussion with Linda. How do you look at ESG at MSCI: is it a risk issue, or a potential return issue? How do you position that when you deliver your research and data to clients, or when you're talking with asset managers and asset owners?

Linda-Eling Lee: I think integrating ESG into the investment process has become much more of a focus on risk. Our analytical approach is very much risk focused. What we're looking at is how well positioned companies are in the face of medium- to long-term macro level trends that may currently not be apparent, and/or ESG-type events that have become more relevant in recent years.

Fundamentally, I feel like this year has been a really good one for piecing out whether ESG should be performance-orientated or risk-orientated, because we have seen a number of studies published that have tried to tease out some of the unique signals of ESG, and whether or not they should be in combination with other risk factors.

In particular, I'm thinking of a recent webinar by Northern Trust and moderated by Responsible Investor looking at the results of ESG signals. What I really liked about it was the way it looked at ESG risk signals on top of a quality portfolio and a quality strategy in order to get extra performance.

I think that is a really important piece of this discussion: we should be looking at ESG as complimentary to financial analysis and investments. This is generally the way that we approach it when we talk to our clients about ESG.

Hugh Wheelan: Are there examples of that risk element you can speak about? What's an issue investors might have picked up on had they been thinking differently about the risk models they use?

> "Fundamentally, I feel like this year has been a really good one for piecing out whether ESG should be performance-orientated or risk-orientated"

Linda-Eling Lee: Yes, this year we put out a number of thematic research reports looking at specific issues. One of the things that we looked at just a few months ago was the issue of water, because this is something investors have been talking about a lot. Obviously everyone understands the availability of water is something that can't be taken for granted, but what does that actually mean for your investment portfolio? How do you look at whether or not the companies that you hold are specifically exposed to it, and to what extent?

When we look across the entire portfolio of companies, you can really drill down to which sectors and which companies may have percentages of their revenue impacted by a production disruption to their generation. For example, you can look at utilities.

Some of the findings that came out of this study are that a lot of water exposure risks are very, very concentrated in just 15 to 20 of the 158 industries that we look at. And even among the utilities companies, which are by far the most exposed companies in the industry set, you have a large range in terms of risk.

It's the same thing with mining companies and extractives: there are companies whose reserves are located in parts of the world, in South Africa for example, where water risks are very serious.

There are quite a lot of examples like this where with any one particular thematic issue, it's important to figure out where the hot spots may be in your portfolio. You can then look at targeting those areas.

Hewson Baltzell: I'd like to elaborate on what Linda said. Our signals do not ever have a short-term price factor. We always say that our research should be used in connection with other fund management strategies and techniques. That's not to say you can't use just our ratings, but I want to be clear we don't have short-term or long-term explicit stock price signals embedded in our model.

We have different clients doing different things with different strategies, but over the last year we've seen some good research using our data, such as from the quant team at Deutsche Bank. One report was focused on smart beta, and it found that there was better risk-adjusted performance and lower volatility using some smart beta portfolios. I think the answer to both alpha and beta is you have to do some work here with this signal, just the way you do with most other signals, to figure out a way to integrate it into your particular strategy.

> "We have different clients doing different things with different strategies"

Hugh Wheelan: Can you tell us a little more about that smart beta approach?

Hewson Baltzell: Well, that particular study took five or six different smart beta approaches, including simple ones like minimum volatility, which are all different ways to construct a portfolio. Essentially the smart beta example I was just referring to took a subset universe of companies rated BBB or above and excluded companies rated below BBB. The approach was to redefine the investment universe to have high ESG performance, then use smart beta strategies on that universe.

You have some clients who don't change the universe at all; they use an optimization model. In fact, some of our indices do that. They're not eliminating any stocks necessarily, they're just using an optimization model, whereas in this Deutsche Bank paper they eliminate BB and below. It's just not part of the universe. We see both of those used fairly often by clients.

> "You have some clients who don't change the universe at all"

Hugh Wheelan: What would an 'optimization strategy' mean, exactly?

Hewson Baltzell: Typically, weighting things more or less, but otherwise not straying too far from an index. For example, putting more weight on companies with high ESG scores and less on those with low scores, but otherwise not being far from the index in terms of other financial measures.

We also have clients who, from a ratings standpoint or for their own value reasons, say, 'I want to exclude that; I do not want to own it.' Or we have clients who want to eliminate fossil fuels for risk reasons. They want to have a fossil-free index.

In that case, we actually did a test where we looked at the MSCI All-Country World Index – a broad index – over about five years. We eliminated coal producers and a number of other heavy-reserve companies, but not refiners, not miners, etc. Over that time period, after eliminating them, we still had very little difference in performance, which was interesting to me.

> ". . . based on past performance, you could have actually followed a fossil-free strategy at no cost"

From a risk standpoint, this says to me that based on past performance, you could have actually followed a fossil-free strategy at no cost. You can avoid your own perceived risk. If you believe it's a risk to own fossil fuels, then you could have avoided that risk without actually having differential performance settings or bad performance.

Bruce Kahn: We did a similar study, and while it is true that your returns may have been similar, your risk factors change dramatically. You eliminate a certain set of companies or sectors, but the optimizer is thinking you will allocate that capital to other sectors.

Sarah Cleveland: Linda, one of the things we're hearing in talking to investment consultants that aren't active in the space is: 'We don't really know what you're talking about. How do we do this? And we really want to see evidence that it does have an impact.' So, in your water example, how would you take that knowledge of that water risk and actually put it into an optimization, or more systematically use it to improve the outcomes in a portfolio?

Linda-Eling Lee: There are three different answers to that.

One approach would be to look at outliers. This would mean flagging companies that have outsized risk exposures or particularly weak risk management relative to peers, triggering more due diligence on the part of investors.

This cannot be necessarily the sum total of all the information you're going to want to have about a company's risk, but if you have very broad holdings being able to identify that handful of companies that might be exposed to particular risk factors is one way to flag that within the investment universe. We've seen clients use that strategy very successfully.

Then in terms of more systematically exploiting certain signals, clients can start looking at the rating and adjusting for the various flags that we've talked about. They are then able to see whether or not it can have a performance effect in combination with their different investment strategies.

Sarah Cleveland: Just one thing, to clarify, when you say 'signal,' are you talking about the trends? How frequently are they updated?

Linda-Eling Lee: When we say 'signals,' we're talking about lots of different levels at which you can look at the information. At the top level, we produce a rating signal, MSCI ESG IVA, that is a best-in-class rating from AAA to CCC for any particular industry, where a company is rated against industry peers on the issues that are materially relevant to those companies in that industry. We don't rate them on their health and safety practices, for example.

> "When we say 'signals,' we're talking about lots of different levels at which you can look at the information"

But you can go down any level below that. For example, we know certain managers are much more interested in environmental risk. They might therefore only look at certain issues, certain signals, certain scores, and the benchmarking that underlies a lot of the information that we're assessing companies on.

Now, most of the studies and the evidence that we're talking about has occurred at the top rating level — the AAA to CCC signal. It's interesting that you bring up momentum, because I think that's a very unexploited part of what we have been doing in ESG.

Earlier this year we put out a study, "Optimizing ESG Factors in Portfolio Construction," where we were looking at three different strategies to see how to incorporate the signal into a benchmark where we're trying to track the benchmark index very closely with very low tracking error, but still improve the ESG characteristics of those portfolios.

I think the most interesting finding was that even though all these strategies were able to improve the ESG characteristics of the portfolios without any type of a performance penalty, the one that actually performed the best was one where there were no exclusions at all. It had every single stock that was in the benchmark portfolio, but what it did was overweight the companies that over time had been showing upward momentum in terms of improving their ESG strategies and underweight the strategies that were having a downward trajectory.

> "I think the most interesting finding was that . . . the one (strategy) that actually performed the best was one where there were no exclusions at all"

Hugh Wheelan: Was that over a specific timeframe?

Linda-Eling Lee: 2007 through 2012. We are going to be updating the study, and we've been asked to incorporate more beta type strategies as well as the smart beta type strategies that we've been talking about.

Julie Moret: I think it's very difficult to talk about alpha or risk factors by disentangling them because when you think about alpha and risk they're very much two sides of the same coin.

What's interesting is that in a lot of the case studies you talk about you are integrating ESG signals in a disciplined, systematic, quantifiable approach. My observation is that this is generally not the norm in our industry at present. I include our company in this because we're in the very early days of applying more quantitative tools in our ESG program. There are several steps that need to occur to understand how to use this type of information in both a qualitative and quantitative manner.

Hugh Wheelan: Julie, can you talk a bit about how you do risk management at the moment as an asset manager?

Julie Moret: We have a global investment risk and performance team that's made up of 100-plus individuals spread over 18 locations. Our risk consultants are actually embedded within the investment team, so they generally sit alongside the portfolio managers and research analysts. We have a separate reporting line into the global head of risk and performance to maintain independence. We produce fund review evaluations on a systematic, regular basis, where we're analyzing traditional ex-ante risk measures alongside ex-post performance attribution. Our objective is not necessarily to avoid or eliminate risks but to ensure we have understood the risks, and that they are an intended part of the investment strategy and have the potential to be compensated. Put another way, we want to ensure our alpha bets are reflected in our risk allocations. What my team is focused on is introducing ESG analytics into this fund evaluation process, so that ESG exposure analysis at the security and portfolio level becomes a holistic part of the ongoing risk management dialogue and communication.

> "Our objective is not necessarily to avoid or eliminate risks but to ensure we have understood the risks"

By leveraging the established investment risk framework we are able to introduce ESG considerations in a disciplined, systematic and structured manner.

Hugh Wheelan: Why have you decided that it's a good time to be thinking about ESG factors alongside your existing risk structure?

Julie Moret: First, I think terminology in this industry can be a hurdle, especially around the term ESG. I often think that it's not a particularly useful term. In my conversations with portfolio managers and analysts I tend to strip away the terminology and focus on the intent, i.e. the objective of ESG, which is very much in line with meeting our primary objective of achieving long-term, sustainable, risk-adjusted returns.

> "I think terminology in this industry can be a hurdle, especially around the term ESG. I often think that it's not a particularly useful term."

We think about ESG as a natural extension of effective risk management. You have your wonderful range of traditional risk measures that come out of various risk models, but the reality is you need to apply some overlay to that information because quantitative risk models don't often capture some of the more qualitative elements of risk, like management quality; the intangible risks.

Linda-Eling Lee: With regard to Sarah's earlier question, Julie could you say a little bit about how you, tactically speaking, were thinking about looking at the ESG information alongside the financial information you're already looking at? Can you talk about the practical application?

Julie Moret: One tangible way we're doing this is that we are subscribing to MSCI's ESG Research, a component of which is the IVA company and country ratings. This type of information enables us to frame the conversation with our portfolio managers and analysts. But don't get me wrong, there's a lot of work still to be done. We're just scratching the surface, but this provides us with the mechanism by which we can open up the dialogue and have those ESG focused conversations.

> "we are subscribing to MSCI's ESG Research, a component of which is the IVA company and country ratings"

Hugh Wheelan: What do your fund managers and analysts think of this?

Julie Moret: You know, this is why I think ESG isn't a particularly useful acronym. We spend a considerable amount of time initially getting the fund managers and analysts comfortable that this is mainstream and consistent with the objective of achieving long-term, risk-adjusted returns. It's not about blacklisting. It's not about screening. It's about the financial impact. Having a conversation in those terms has helped to further that conversation. Franklin Templeton has a long tradition of managing assets aligned with social and religious goals and restrictions and we are proud of this tradition, but our ESG program is distinct from this and really applies to all our assets under management.

Hugh Wheelan: Portfolio managers in my experience tend to be of the opinion that they already know the downside risks that are possible in their investments. They've thought about all of this stuff. How dare you come in and suggest they haven't…

Julie Moret: What we're doing is bringing additional insight and context to their security and portfolio level exposures. I also think it's the way you approach it: the quality of the communication and engagement. The bottom line is that they're the fund managers and they know their individual investments inside out. At a minimum, the fund managers already know a lot of what we are providing, so it's an independent validation. At best, it could possibly yield a certain element of their research that they may wish to investigate or explore further. It really enables us to just have that dialogue and hone in on questions.

> "The bottom line is that they're the fund managers and they know their individual investments inside out"

Mary Jane McQuillen: I think what often happens - and I think everyone will agree with this - is that responsible investing or impact investing gets painted with very broad brush strokes. Each of us has our own particular approach to responsible investing and portfolio construction, whether active or passive equities,

bonds, alternatives, funds, separate accounts, etc). What Julie's been describing is very interesting. For us, the concept of managing risk, particularly around ESG investing, for example, would be within our fundamental team. Our analysts would be identifying and quantifying the risk factors in their stock coverage. And just to clarify, we're active managers; so within our universes we may take concentrated positions from 30 to 50 names. We manage equity styles that range from moderately conservative to higher active share.

Our observation has been that the consumer analyst has a different view on risk than the energy analyst and the financial services analyst, and so on. It's interesting to note how different firms may have varied interpretations. I think it's good to appreciate the differences.

> "Our observation has been that the consumer analyst has a different view on risk than the energy analyst and the financial services analyst"

Hugh Wheelan: For you it's seen as very much a part of the financial research you do?

Mary Jane McQuillen: Yes, but it's walking a fine line. We have historically had the mindset in the U.S. that supporting investments and "principles/ethics," or the environment, will have a cost associated, or that these actions

are a negative for business. Yet, for many of us in this room, that's an old mindset. Investments today can yield results for tomorrow.

Regarding product names, many of us have clients who want to see "ESG" listed as part of their products, so we list them as ESG, but in our view if we wanted to remove the ESG label, our process would be virtually the same in terms of the fundamental research. All of our sector analysts are compensated for their ESG research integration, regardless of which product. But it seems that investors want to see the ESG label for verification. Most of the market is not currently integrating ESG and so the distinctions are made regarding sustainable long-term investing because you also want to acknowledge that there is something taking place.

Hugh Wheelan: Is it looking at the way investment is done in a different way?

Martin Grosskopf: I think you have to take a step back and say: 'Do most portfolio managers really care about sustainable investment?' I would argue that most portfolio managers are interested in unusually large profits. In Canada, we've had an interesting example with the railroads and Canadian National Railway and Canadian Pacific Railway have been amazing investments for most portfolio managers over the last few years. There are very few portfolio managers that are particularly interested in the risks of rail and oil. Even the tragedy that recently happened (2013's derailment in Lac-Mégantic, Quebec, that killed 47 people) did nothing to the share price of the stock. Most managers I speak with, are saying, 'Look, it didn't hurt my portfolio, so why are you talking to me about this?'

> "I would argue that most portfolio managers are interested in unusually large profits"

Hugh Wheelan: Is there any sense that what you hear in this area would likely translate into different ideas, or some of the tests that Mary Jane was talking about?

Martin Grosskopf: I think there were excellent points made that it all depends on the manager's particular approach to taking on risk. I think, at least the way I manage my systematic environmental portfolio, that there are tremendous opportunities for upsides based on thematic trends. Water, as an example, or energy efficiency, may be thematic trends managers can benefit from. There's many along those lines. But to say these are factors that you need to look at, well that's bringing a whole political view to the table. We've been trying to get rid of the values-laden discussion since the term ESG was coined, I think, in 2003. The term was coined because we didn't want to talk

> "We've been trying to get rid of the values-laden discussion since the term ESG was coined, I think, in 2003"

about ethical investing anymore. Now we're at the point of saying we don't need ESG anymore. Eventually you get so far beyond the point of why you were doing it in the first place, you just talk about risk. To be honest with you, there are plenty of managers who would say they want to short the best companies out there. They're scoring highly.

> "The true long-term investors and asset owners, their point of view is absolutely important, but when they're hiring a manager they're hiring a tool within a toolkit"

They're all AAAs. Perfect shorts, right? You can use that information both ways. So don't think you're going to have some objective at the end that is met through the use of ESG analysis. You can break that data so many different ways, and people can use it for a six-month return, a two-month return, a one-year return, a five-year return, depending on what their horizon of ownership is. The true long-term investors and asset owners, their point of view is absolutely important, but when they're hiring a manager they're hiring a tool within a toolkit. And that tool is useful for a period of time and it's discarded as soon as it's not useful.

I was talking recently about climate change with a portfolio manager that runs natural resource funds. And even on the basic principle of climate reporting - CO^2 reporting from oil sands actually, the manager said: 'Why would I want to know that?

If that information gets out and they're spewing out all sorts of CO^2, isn't that going to hurt the share price?" Her point of view is, 'I'm probably not going to own this thing a year ahead, and you're talking about a risk that may come to the fore 10 or 15 years from now.' She may be right. My point is: don't stress factors that really aren't going to be material. Some of these factors in terms of returns are not worth spending a lot of time on. Portfolio managers often have an intuitive sense of that.

Sarah Cleveland: I'm wondering, what's the harm about incorporating something that's intentional and systematic?

Martin Grosskopf: It's about resources. Portfolio managers have limited resources and they don't want to spend a lot of time doing a heap of reports. I've had very successful managers say: 'Go take your template and . . . Here are my numbers. I have excellent returns, I'm beating my peer group over two, three, five years and I don't have time for more templates, whether or not they contain ESG data or not.' They just don't want to do more reporting. To be honest with you, I think we sometimes toot our own horn a little too much in terms of our ability to identify future risk. You know, BP was highly ranked. I used to work as an engineering consultant on

> "I think we sometimes toot our own horn a little too much in terms of our ability to identify future risk"

the environmental side. I probably wouldn't have known they were going to have a blow-up. Do you think the data would tell you they're going to have a blow-up? What I think is ironic in a way about this whole process is that we're getting so far from mentioning the term 'values' that we are losing a little bit of the insight into why this whole area existed in the first place. There was a purpose to it. It was like-minded people with a purpose. Margaret Mead said a small number of people can change the world, and that's the only way the world's ever changed. Now we're saying that doesn't matter anymore; it's just about risk.

Hugh Wheelan: Do you hear from clients who say: 'We hire you for a certain period of time, but we have a set of criteria that we want you to use because we believe, as long-term investors, we'd like our asset managers to be thinking about these.' Do you ever get that?

Martin Grosskopf: I've had it both ways. I've had a very high-profile institutional client say: 'This is what we're about and we've got a large number of risk factors we want you to consider. We want reports on climate risk.' I've also had PRI signatories as clients who have never mentioned it in the meeting when they hired our firm as a mainstream manager.

Hugh Wheelan: Rob, do you want to talk about your experience around some of the discussions we've heard?

Rob Wilson: Regarding what Julie was saying about portfolio managers not wanting to necessarily talk about things from an ethical perspective, I think it's completely reasonable. Fund managers have got to where they are because they have a process that's been very successful, and they've sold that process to a set of clients. So they should be very careful about any addition or subtraction to that process. My personal interest in ESG may come from an ethical perspective, but professionally I, and our portfolio managers are thinking about their clients first. One thing that I try to do is to take some of the knowledge that we get from the MSCI mining analysts, for example, on water use, and incorporate that into what the utilities analysts are thinking about to create some dialogue across sectors. This is an example of where I think an ESG or sustainability analyst - or just call them a cross-sector analyst - can add some value. He or she can help advance the dialogue on these topics by finding out where the lines of communication are not open in an organization and open those a little bit more around some of these topics.

> "My personal interest in ESG may come from an ethical perspective, but professionally I, and our portfolio managers are thinking about their clients first"

The last thing I'll say on this front is that I've noticed that there is a continuum from shorter-term focused/higher turnover portfolio managers to longer-term focused/lower turnover portfolio managers.

That matches the 'very unlikely to talk about ESG issues' to 'very likely to talk about ESG issues' continuum. The portfolio managers that have long time horizons with 10% annual turnover, they want to talk about this. They want to know what's going on. They hear clients asking about it. That lower turnover, longer-term investing mindset is more consistent with how MFS manages money, which is why over time, I can see more ESG research becoming part of our fundamental security analysis process.

I think it's important for any of us in the ESG analyst role to keep that in mind, because those are the people with whom we can have an impact. Then we can maybe show the shorter-term portfolio managers that there is some value here and that maybe they should be spending a little bit more time thinking about it.

Hugh Wheelan: Brace, do you want to talk about how you approach ESG as an organization? How it's picked up internally and why?

Bracebridge Young: We're very new to the discussion. As a fixed-income focused long/short hedge fund manager it wasn't necessarily part of the vocabulary in any part of our organization. But from my perspective, when I look at our business, it was very clear that over the last four or five years the tempo was picking up a lot in the discussion among institutional investors.

> "As a fixed-income focused long/short hedge fund manager it (ESG) wasn't necessarily part of the vocabulary in any part of our organization"

We felt strongly that if our clients were asking, it was worth being at the table. We believe if you're not engaged then you're not part of the evolution. You're making a mistake as a business from a return, client-retention, and client-acquisition point of view. We looked around the industry and found MSCI. We didn't have the resources to replicate 100 analysts and 14 locations, so using the MSCI screen allows us to at least know what the issues are as evaluated by them. It's put us in a position to be engaged with our clients and begin the discussion. We signed the PRI. A number of consultants are now giving ESG scores to managers.

At least we now have the capability to say we review ESG. We have a long way to go. The whole industry has a long way to go. Anybody who thinks they have an answer is crazy. But I think it's important to be part of the dialogue. However, we do believe our clients are very clear about this. They want this to be incrementally positive to their return. It has to either be risk reduction or alpha, but either way, you have to get a better return with the activity. I would say a couple of interesting things have happened internally for us.

> "The whole industry has a long way to go. Anybody who thinks they have an answer is crazy"

First of all, it unquestionably changed the dialogue. The managers, they may or may not embrace it all, but they're actually involved in discussions they were never involved in before. Secondly, it's been very positive internally for our staff. Our institution feels that by signing the PRI and taking this approach, it's been valuable for internal morale.

As I talk to people, both institutions and individuals, there's very little consensus around what they're looking for but they're really pleased we're engaged. I think we'll all look back ten years from now and there'll be very different conclusions. But the people who will be winning will be those who were involved in the debate.

Hugh Wheelan: Bruce, you're a fund manager looking at opportunities based around sustainability. Do you want to talk about why you think there are opportunities out there, and where the kind of research that we've been talking about can be applied in looking for returns? You talked a lot about risk, but you're obviously not going out and saying, 'We're going to sell you risk awareness'; you're saying, 'We're going to deliver returns based on sustainability,' right?

Bruce Kahn: Sure. We are focused on risk-adjusted returns. It kind of plays off Sarah's comment about: 'What is the purpose? And is there a purpose in doing this kind of investing beyond values?' We take the stance that there certainly is a very strong purpose of doing this beyond values. Most people have values. But we have a variety of trends going on in the world, and they are trends that are based in science. One is a scarcity of natural resources. Second is an increase in demand for those scarce resources because of population growth and climate change. These factors are real. Our purpose, then, is to understand those trends. What are the rules and structures in place, and how can we deploy capital to not only manage the risk but take advantage of the opportunity?

> "We take the stance that there certainly is a very strong purpose of doing this beyond values"

And we're not working in the 'hypotheticals' like eliminating all subsidies from the fossil fuel industry. We're looking at the trends in the markets over the next five to ten years. Investing is about what you think the future will be in five years. There is an overlap with what you think the future *should* be, but as an investor you have to think about what the future *will* be. Coming back to the difference between value and values. I think many of us got into this industry from a values perspective, but realized quickly that it is about value and that the capital market is a tool for society to price and re-price what these issues are. This is what our firm calls 'sustainability risk.'

> "There is an overlap with what you think the future *should* be, but as an investor you have to think about what the future *will* be"

Hugh Wheelan: So there's almost an explicit ESG approach required to go into new and different areas of return, you're suggesting? And themes that maybe haven't been exploited much yet?

Bruce Kahn: Absolutely. You raise two important issues: one of returns and the other of themes. When looking at returns you have to look at the associated risks. As active managers we look at inefficiencies in the pricing of assets, and some of those inefficiencies we have identified are ESG factors. In other words, does ▶

the market effectively price in the risks associated with poor environmental, social or governance issues? We believe in a number of instances that this is not effectively priced into the stock.

On the second issue of themes, let's look at the broad trends of the world. Where is growth going to come from? We need to look at agricultural development and infrastructure. Where is the world going to be putting capital in the next five to ten years? Where is industrial output coming from? IHS did some estimates that show that the food and agri business was 8.7% of industrial output. And the largest sectors of growth over the past five years were food and agri businesses. How much did investors put into that? Less than 1%....There's a disconnect between what's happening in industry and what institutional investors are doing.

> "Where is growth going to come from? . . . Where is the world going to be putting capital in the next five to ten years? Where is industrial output coming from?"

Linda-Eling Lee: How do you reconcile this macro, forward-looking view of the world with your need to produce annual or quarterly returns? Circling back to Martin's point, I feel a tension among some of our clients who are asset owners and others who are very short-term managers. Often the way I talk about it is as sustainability risk at two different levels. One is the macro level where over time the economy is going to have to rebalance because of longer-term externalities: i.e. the world tomorrow is going to be quite different from the world yesterday.

There are also day-to-day externalities where companies aren't necessarily bearing the full cost of negative externalities regardless of what the macro-level trends are. We see that tension a lot. We have the research and data to do 'event' risks versus long-term macro-level risks. I find myself talking about one versus the other depending on what kind clients are interested in and what types of ESG risks are applicable. How do you deal with this?

Bruce Kahn: It's very much like sailing! I'm going to take a boat full of grain from Seattle over to Beijing. I know where I'm coming from. I know what my longitude and latitude is, and I know where I have to go. But when I get into the ocean, I've got currents, waves, and other boats to think about…and potentially non-friendly boats. So you have to be tactical.

> "On a day-to-day basis, we rely on the modern, current investment tools that MSCI ESG research and other vendors provide"

On a day-to-day basis, we rely on the modern, current investment tools that MSCI

ESG research and other vendors provide, as well as our own research, to give us information about where we are in the ocean and what the weather is like on a given day. You have to be monitoring all the risks. The bottom line is that asset managers are expected to deliver superior returns.

There is always pressure to deliver such returns, both in the long- and short-term, whether you are running an investment process that includes sustainable factors or one that ignores them. If sustainable investing is to compete head-on in the mainstream arena, it needs to compete on the same rules and this means justifying short- and long-term performance. In other words, you really need to look at the forest from the trees, but you also need to be looking at the tree itself.

> “you really need to look at the forest from the trees but you also need to be looking at the tree itself”

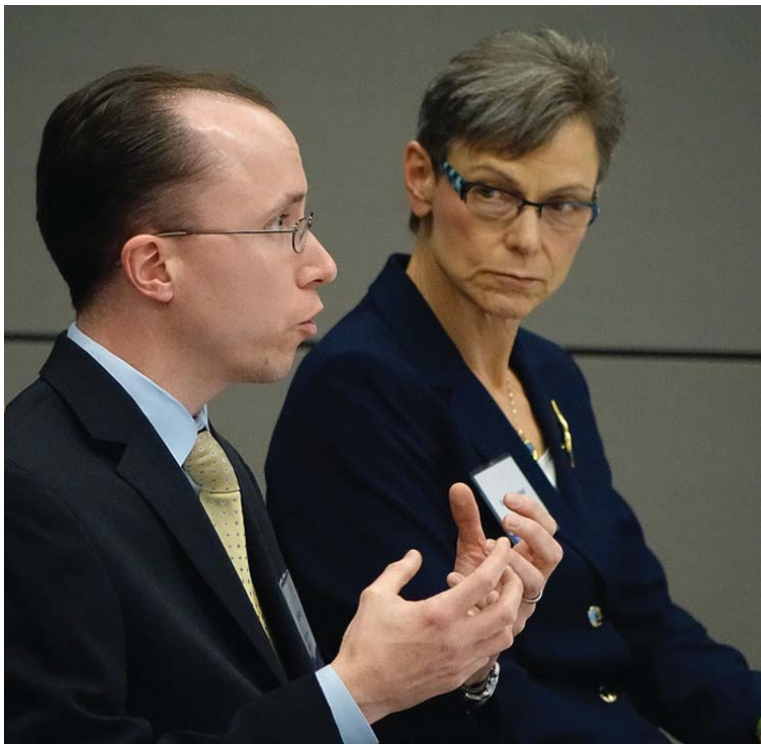
That's where the role of the analyst is very important. Not only the ESG analyst, but the fundamental analyst. I think there's a lot more information to study about the role of the financial analyst in this whole discourse. Are they covering ESG? Will ESG become the new normal in their processes, both on the buy and sell side? If we think that ESG is going to become part of the normal investment process, then maybe this whole industry kind of works itself out of a job. I think that's not likely.

However, there is an even broader and more pernicious fundamental flaw in the financial management industry, which is that asset owners and asset managers all strive to be median. That's why 70% of asset managers underperform their benchmarks. That's why most commodity investors lose money. That's why most people are very fed up with Wall Street in general. The industry does not deliver what it promises. Everybody says they want to be top quartile, but nobody is. Not only do you have to question whether ESG gets embedded into the industry or not, but we have to think more fundamentally about how the industry works. Nobody wants to be in the middle of the bell curve. Everybody wants to be on the far end of the bell curve, but very few people are.

> “asset owners and asset managers all strive to be median . . . That's why most people are very fed up with Wall Street in general”

Hugh Wheelan: Is ESG part of the solution to that problem, Bruce? Is it generating themes or ideas?

Bruce Kahn: Yes, and I think that's exactly what we're doing here with the MSCI/ESG research. The role of ESG research is to provide analysts with a lot more data to be making better decisions.



Rob Wilson: I think that's true because I have seen some inconsistency in the way analysts address these issues. When I sit down and talk with them, some have clearly thought through these issues, although they might not call them ESG. Others have not spent as much time on them and appreciate more concrete data. I think where we can add value as ESG analysts is by establishing consistency and helping analysts or portfolio managers see that these issues do matter. That's when you start to see, for example, that the mining company that has a poor history of stakeholder relations is going to have a valuation discount versus its peers. Once you see that, you have a management team saying: 'We need to correct that difference; how do we do that? We need to understand more about this.' Businesses changing their behavior to reduce risk; that's what we're clearly looking for a company to do, which has long term benefits to itself, its stakeholders and its shareholders.

Hugh Wheelan: What's the actual investment quality that can be attained from ESG research and are you seeing the kind of research that might push back on some of the critiques from portfolio managers?

Rob Wilson: Well, there is an assumption of quality data. An organization like MSCI ESG Research couldn't exist without an assumption that the engineers that are collecting the environmental data at a plant level are doing a good job, and there's no way you're going to actually send an analyst in to figure that out. But, that said, you don't do that in financial analysis either. A portfolio manager relies on a portfolio company's auditors to check the firm's inventory and books; they can't do it all themselves.

> "A portfolio manager relies on a portfolio company's auditors to check the firm's inventory and books; they can't do it all themselves"

Hugh Wheelan: There have been plenty of company examples where you've either seen a governance or a business model blow-up. Is ESG analysis potentially able to fill those kinds of research gaps or not? Is that unrealistic?

Rob Wilson: There may be one or two factors. A hedge fund or an activist investor might find that factor within a particular company and, say it's governance-related, go in and make billions of dollars by changing the governance structure of the firm. But I'm more interested in rate of change, whether it's earnings momentum or rate of change in analyst rankings or in ESG factors. I don't necessarily look for the leader. I might be looking for the laggard that's improving because that's how I'm going to uncover more value. I don't think there's one answer to your question.

Julie Moret: I think tracking some of these factors or considerations through time can help give insight. I don't think it's so much about the range of ESG data out there. It's more about tracking the history of some of these factors and analysing some of the trends. One of the questions I always ask when meeting with ESG research providers is to what extent they have a history of this information? How are they tracking this through time? Understanding this historically can give some insight into forward-predictability. You need to look at the context of ESG information alongside more traditional valuation/risk information. But what's missing, I think, is some level of history.

> "You need to look at the context of ESG information alongside more traditional valuation/risk information"

Hugh Wheelan: How much does this have to do with a lack of broker research on these issues?

Julie Moret: My view of broker research is it's really hit or miss. Some brokers seem to just throw in everything under the sun and there's no linkage. And then there are those trying to figure out what they should be doing. I think some broker research out there, UBS and Citigroup, especially for Australia and the mining industry, is incredibly detailed. But when you compare that to some of the other brokers out there, there's a vast divide in quality. There's one big brokerage house that has recently established an ESG function. They're trying to mainstream it but they seem to be throwing in everything under the sun, though I can appreciate they are figuring things out

Hugh Wheelan: Do you think investing in more difficult markets - where regulatory structure is perhaps not as clear, or where corruption can be an issue – is driving more interest in ESG?

Julie Moret: Having spoken to our portfolio managers and analysts it's apparent that when they've invested in some of the more difficult markets such as frontier and emerging markets they've had to do much more due diligence around consideration of political risks and ESG factors where they have the potential to be financially material. It's not that ESG has suddenly driven them to do this. It's always

been a component of their fundamental research, it's just that our analysts don't carve out this element of the work they do and call it out as a separately labeled ESG component. It's very difficult to go into certain emerging or frontier markets without understanding the business environment. It's fair to say it's the DNA of that kind of fundamental research. Where we come in is looking at those types of ESG risks and opportunities in a much more disciplined and systematic manner, and often helping them to draw out the linkages.

Rob Wilson: In the emerging markets for MFS, governance is one of the key pillars that the analysts look at for any stock that they're talking about.

Hugh Wheelan: I'm interested to hear whether targeted strategic ESG information is perceived as valuable to the other fund managers here?

Martin Grosskopf: You know, I think that my favorite thing to do as a portfolio manager is to go against the grain. It's what I think most portfolio managers like to do. I think there's an entrenched set of values within the market, actually, and it's easy for people in this room to go against them. When I see mining financing done, I see the great majority of money managers say: 'Management says it's okay. We're going to move that village and we're going to build the mine; let's give them $200m dollars.'

> "I think that my favorite thing to do as a portfolio manager is to go against the grain"

That's the standard within the market in order to assume that social and environmental risk is manageable. It's helpful when you have the knowledge to say: 'That seems a little odd.' It's like when Trans-Canada says that the Keystone pipeline is not going to be a problem, and then the next thing you know actresses are getting arrested at protests and it's all put on hold. The most interesting thing to me is to use environmental data and knowledge of regulatory approvals.

> "It's helpful when you have the knowledge to say: 'That seems a little odd'"

So, you could take the perspective that Trans-Canada is too buoyant in its views and it's a good time to get out of that stock because there's too much expectation related to Keystone.

The other side of it is to use that data to go into Trans-Canada and say: 'You know what? This issue is overblown.' That, to me, is using the data in as raw a form as possible. I'm trying not to take a stance in investing on either side of that equation. The idea is that I can draw things out of a company report that aren't regularly read and assessed by analysts, or get a sense of overconfidence from meetings with management. It's more the art than the science. But when I go into meetings with pension consultants or clients, it's always: 'What's the definitive thing?'

Mary Jane McQuillen: They ask: 'What's the checklist?'

Martin Grosskopf: Right! Sometimes they're so simplistic. One factor…that makes the difference? You think we wouldn't have figured it out already? Things change. Twenty years ago, the pillars of socially responsible investing were governance, screening and community investing. Now, governance is mainstream and everyone talks about impact investing.

> "Now, governance is mainstream and everyone talks about impact investing"

Mary Jane McQuillen: We've found that it's key to note the differing opinions - or consensus - in applying these terms and how the research adds value to the investment process. We like more ESG data if the data is relevant to the stock recommendation.

We think it helps, but we believe our analysts have the most appropriate experience to analyze the material issues for companies and sectors. For example, we were on a call today with one of our newer holdings. We wanted to discuss their sustainability strategy, and they (Investor Relations) started rattling off how much they recycled paper and that they turned the lights off at night.

We said: 'This is not what we're talking about with regard to ESG data and strategy.' We realized that they didn't really understand what we were talking about as far as

sustainability, and how we would have wanted to see it integrated into their business model.

They were very curious to hear more, and if anything, to be prompted to share more information. But since they hadn't been asked to articulate their sustainability strategy on a regular basis, this was new territory for IR, but not for the business unit heads we later met with. The reason we liked the company was that we knew there was more information to be found than they were unconvincingly conveying. I think the current ESG data out there is somewhat informative, but the analyst needs to be able to do something with it. It has to be meaningful. It helps when the ESG data adds to our conviction level for a stock.

Sarah Cleveland: I just want to say that I appreciate the comment about the 'art' and 'science' of research. That's absolutely true, and I think the stronger consultants are incorporating that. I think the checklist idea of trying to make sure everything's being covered well for investment doesn't add up. There's a lot of judgment in all of this. We can try to quantify: every consultant wants to see your buy-discipline and your sell-discipline, your methodology and your research areas. But in the end, people are making adjustments, at least on the active management side. Sometimes it's those very skilled managers who have an art in their skill. I think the distinguishing value is: how can you identify a manager that has a repeatable process that can add value on a consistent basis?

> "I think the distinguishing value is: how can you identify a manager that has a repeatable process that can add value on a consistent basis?"

Bruce Kahn: I'd like to maintain an emphasis on the aggressive management of unintended risk. A lot of artistic portfolio managers may have great returns in one type of market, but they take on a lot of unintended risk that they don't necessarily realize. You might not manage those risks, but you should understand where they are. ESG is a huge unintended risk many investors are taking that they don't even know about!