ESG Trends

Key Global ESG Trends

- Interest in ESG continues to grow and the market is currently dominated by institutional investors comprising 86.9% of global ESG AUM.[i]
- Iran is the only country—out of the top 50 economies by GDP—with no policy initiatives relating to ESG factors and investment.[ii]
- The different approaches to ESG investing in Australia, Europe and the United States are a result of governmental, geopolitical, historical and cultural factors.
- Motivations for ESG investing range from a desire to align institutions' values to their financial returns, to abiding by increasing legal obligations.
- Many Asian countries have created or are in the process of creating stewardship codes aimed at improving engagement between companies and investors.[iii]

Environmental, social and governance (ESG) investing can no longer be considered a niche market. In fact, 97% of leading global CEOs currently consider ESG factors as critical to the future success of their companies.[†] Assets under management (AUM) that are defined as "responsibly invested" have grown dramatically over the last 10 years. The method of integrating ESG factors into investment research has evolved considerably from the times of merely excluding companies on the basis of moral values.

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This paper takes a deeper look at the evolution of ESG investing. We highlight recent macro trends and popularity of different ESG investing approaches in three developed markets: Europe, Australia and the United States. Additionally, we discuss recent developments in Asian countries, surrounding the potential for higher awareness of ESG factors.

ESG Definition

ESG investing is an umbrella term for a range of investment strategies which consider a company's environmental, social and governance factors as part of the investment selection process. Environmental factors examine the ways a company's operations affect the local and global ecosystems. Social factors apply metrics based on the quality of interactions with suppliers, employees, customers and the larger community. Governance refers to corporate self-governance, and includes board independence, transparency and shareholder rights. Methods of ESG investing include positive screening, negative screening, active ownership, ESG integration, impact investing and sustainability-themed investing.

i Principles for Responsible Investment Annual Report 2016

ii Principles for Responsible Investment _MSCI_Global-Guide-to-Responsible-Investment-Regulation 2016

iii 2017 ESG Trends to Watch MSCI

The Evolution of ESG

ESG investing first emerged centuries ago when religiously-oriented, values-based investors hoped to avoid "sinful" stocks such as alcohol and firearms which contradicted their values. By eliminating their exposure to specific industries or individual securities, religious organizations spearheaded initial ESG investing using negative screens. In the 1960s and 70s, the use of negative screening expanded to address political and social concerns. For example, apartheid in South Africa in the 1980s spurred political pressure for companies to stop investing in South African based firms. In 2013, all Dutch financial institutions, motivated by a commitment to stop humanitarian harm, were legally forbidden to invest in the manufacturing, distribution or sale of cluster munitions.[i] More recently, public pressure continues to be an effective force behind new legislation which targets particular ESG issues such as climate change and human rights violations.

Over time methods of ESG investing have evolved beyond negative screening. Current methods—in addition to negative screening—include ESG integration, positive screening, impact investing, active ownership and sustainability themed investments. ESG integration incorporates ESG metrics into traditional fundamental

i *Pax for Peace, Dutch case study: A ban on investments in producers of cluster munitions, August 2015*

Exhibit 1: ESG Components Breakdown

Source: Callan 2016 ESG Workshop Presentation analysis. Managers who use the positive screening approach actively seek out companies with the highest ESG metrics relative to peers (rather than removing the worst offenders via the negative screening approach). Impact investing targets investments in companies, funds or other organizations (mostly within private markets) with the intention of creating solutions to environmental or social challenges. Impact investors have developed a range of measurement methods,[††] such as social return on investments (SROI), logic models, scorecards and randomized control trials, to quantify the social impact of their investments.[ii] Active ownership implies taking an involved role as a shareholder by pushing for specific ESG related changes in the companies that managers own. For example, BlackRock and State Street are devoting more resources into active ownership by pushing companies on ESG principles, including voting against directors and resolutions that conflict with an ESG-oriented direction.[iii] Sustainability themed investments could include a low carbon portfolio or funds comprised of renewable energy firms.

Across the globe, rising interest in ESG investing is likely to continue influencing the decisions and actions of institutional investors. The combined AUM of United Nations Principals for Responsible Investing (UN PRI) signatories grew from $4 trillion in 2006 to $60 trillion by April 2016.[iv]

Exhibit 2: Methods of ESG investing –Definitions

Positive Screening
Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers. This also includes avoiding companies that do not meet certain ESG performance thresholds.

Negative/Exclusionary Screening:
The exclusion from a fund or plan of certain sectors or companies involved in activities deemed unacceptable or controversial.

Active Ownership:
Use of shareholder power to influence corporate behavior such as communicating with senior management and/or boards of companies, filing or co-filing shareholder proposals, and proxy voting.

ESG Integration:
The systematic and explicit inclusion by investment managers of ESG factors into traditional financial analysis.

Impact Investing:
Targeted investments, typically made in private markets, aimed at solving social or environmental problems.

Sustainability themed investing:
The selection of assets specifically related to sustainability in single- or multi-themed funds.

Source: Definitions taken from the Forum of Sustainable and Responsible Investment

ii "How Impact Investors Actually Measure Impact (SSIR)." Stanford Social Innovation Review.

iii Kapadia, Reshma. "A New Era of Sustainable Investing Emerges." Barron's, 11 Feb. 2017

iv Principles for Responsible Investment Annual Report 2016

Europe

Led by the Nordic countries, the European ESG market is well developed and continues to grow across all categories. According to Morningstar, Europe currently has twice as many ESG assets as the United States. With over $10.5 trillion in AUM and 48 percent growth from 2013 to 2015, negative screening is the most popular method of European ESG investing (Exhibit 3). Across the European market, the most common negative screen is for weapons[†††] (production and trade) followed by tobacco. Impact investing is the fastest growing ESG category with a growth rate of 385 percent from 2013 – 2015[v] and covers $103 billion in AUM.

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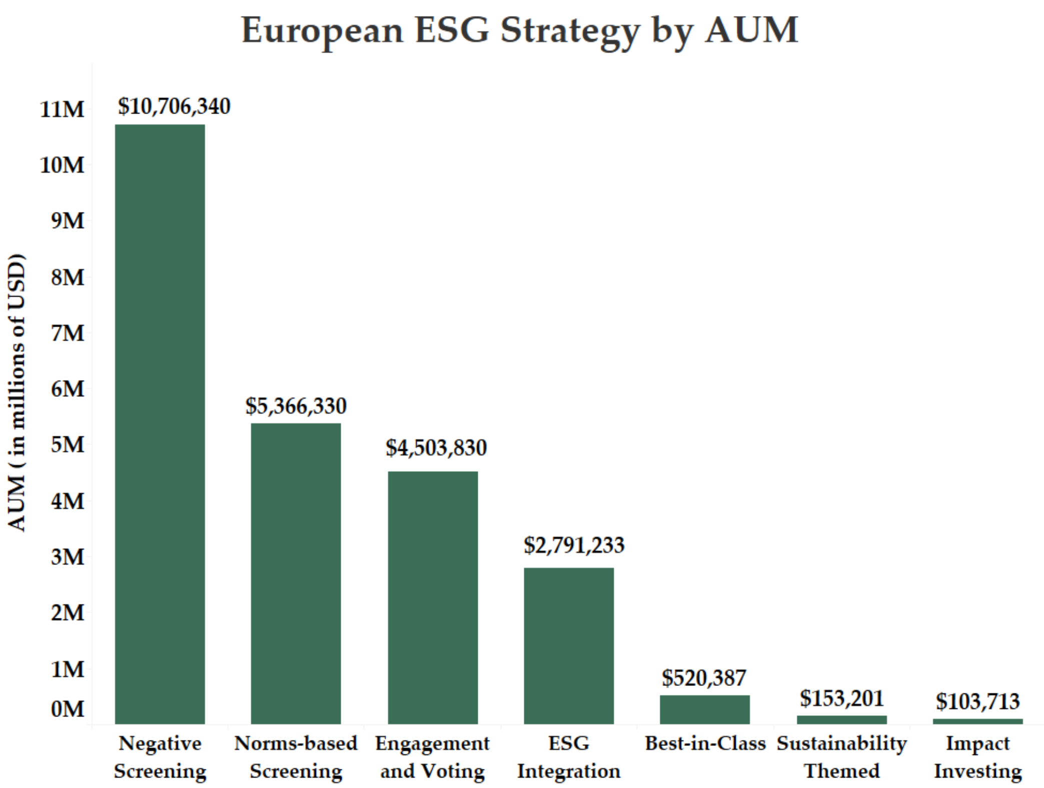
Motivations for European Investors

Influenced by cultural and legislative shifts, European institutions have in general, come to view ESG considerations as an integral aspect of their fiduciary responsibility, and aim to take corporate missions and values into consideration when determining appropriate investments. The Nordic countries—lead by Norway, Sweden and Denmark—have a particularly rich history of involvement in the ESG space.

In September 2016, the European Union (EU) announced its plan to create a sustainable finance strategy for European capital markets. Building on the EU's commitments to the twenty-second session of the Conference of the Parties (COP 21) agenda and the EU 2020 targets, the strategy aims to identify policy measures to safeguard that the financial system supports sustainable growth.

France maintains a leadership role in the European ESG market with the largest amount of AUM in best-in-class, sustainability, and norm-based screening. The French ESG market grew over

Exhibit 3: Overview of ESG strategies in Europe



Source: European SRI Study 2016

v *Eurosif, European SRI Study 2016*

60% in the two-year period between 2013 and 2015 with total ESG AUM at over $791 billion. In 2015, French insurance companies generated 55% of the increase in the volume of ESG investments and represent more than 60% of ESG assets with a total AUM of $490 billion.[vi]

In May of 2015 AXA, a French insurance company, agreed to sell $527 million of coal assets in favor of investing 3 billion into low carbon investments, so as to align its financial return with its mission to fight climate change.[vii] In addition to leading in AUM, France is the first country to require asset owners and asset managers to disclose their ESG integration within their investment policies. This was outlined in Article 173 of the France's Energy Transition law in August 2015. While the impact of such legislation will take time to materialize, it marks an important milestone in the progression of ESG integration into the global investment universe.

Pension fund developments—such as the Swedish Ethical Council and Aiming for a Coalition in the UK—are also key drivers in ESG demand. The Swedish Pension Fund Initiative, Ethical Council, represents a collaboration between the four Swedish pension funds, and aims to advance environmental and social issues worldwide. Dutch pension funds Stichting Pensioenfonds Zorg en Welzijn (PGGM), and Stichting Pensioenfonds ABP have set goals of investing $63 billion in investments that support the Sustainable Development Goals.

In May of 2015, the Norwegian Parliament's Finance Committee issued an undisputed recommendation to divest the country's (and the world's largest) sovereign wealth fund from the coal industry. This $917 billion divestment from 73 mining and power companies was due to risk concerns linked to environmental degradation, corruption, and social concerns that companies with higher carbon emissions—either from direct operations or supply chains—experience higher regulatory risk.[viii]

vi ibid

vii ibid

viii ibid

Australia

As ESG investments are reflected in over half of all professionally managed assets in Australia, the Australian market is in a position to become a global leader in the ESG space.[ix] Australian investors, led by institutions, are increasingly utilizing ESG factors in their portfolios. Australian ESG funds doubled in size from $18.5 billion in 2013 to $37.2 billion in 2015.[x] By the end of 2016 the overall ESG market accounted for $458 billion in AUM. Though this is a small slice of the country's AUM, ESG AUM is up 62 percent since 2014.[xi] Engagement in the ESG space by two of Australia's four major banks, Westpac and NAB, provides evidence of growing demand across the Australian financial industry.

> Australian investors' exhibit a growing interest in knowing that their retirement accounts take ESG factors such as sustainability, ethical and social issues into account.

Out of Australia's 50 largest Superfunds [xii]:

- **86% are committed to an ESG investment approach across at least one asset class**
- **70 % have some form of ESG Policy**
- **56% reference ESG in their vision, mission or investment philosophy**
- **68% identified key stakeholders as a critical component of driving demand and altering their investment beliefs**
- **52% indicated that they have some level of corporate engagement**

ix Responsible Investment Association Australasia ,Superfund Responsible Investment Benchmark Report, 2016

x ibid

xi Williams Jonathan, "ESG wave looming on Australia's horizon" ESG Magazine,, Dec 2016

xii Superfund Responsible Investment Benchmark Report 2016, Responsible Investment Association Australasia

Active ownership and ESG integration are tied for the most common ESG approaches in the space, while negative screening is the third most common approach (Exhibit 4). Although impact investing is a relatively small slice of the ESG universe, it may begin to grow quickly as a number of funds are actively exploring possible approaches to allocating further capital to impactful investments.[xiii]

Motivations for Australia Investors

Australian investors' exhibit a growing interest in knowing that their retirement accounts take ESG factors such as sustainability, ethical and social issues into account. Demand for ESG investments is driven by investors' desire to align their investments with their personal or organizational values as well as the growing belief that companies with superior ESG metrics have the potential to demonstrate superior, risk-adjusted, performance. In general Australian funds tie their ESG investing approach with their ESG commitments and beliefs. Funds with an ethical based mission tend to implement ESG through a negative screening process while a fund whose mission primarily focuses on taking an active role would most likely employ ESG integration or active ownership in their investment approach.

In 2016, the Australian Prudential Regulation Authority's (APRA) responsible for regulating asset managers, recognized that ESG risks are financially material. APRA's firmer position on climate change likely paves the way for greater interest in ESG superfunds tied to sustainability. By further announcing its views that climate change as a material risk, APRA's action marks a step toward clarifying the Australian government's lack of opinion on climate issues. The Australian government's position may further facilitate increasing sustainability and climate oriented investments.

xiii ibid

United States

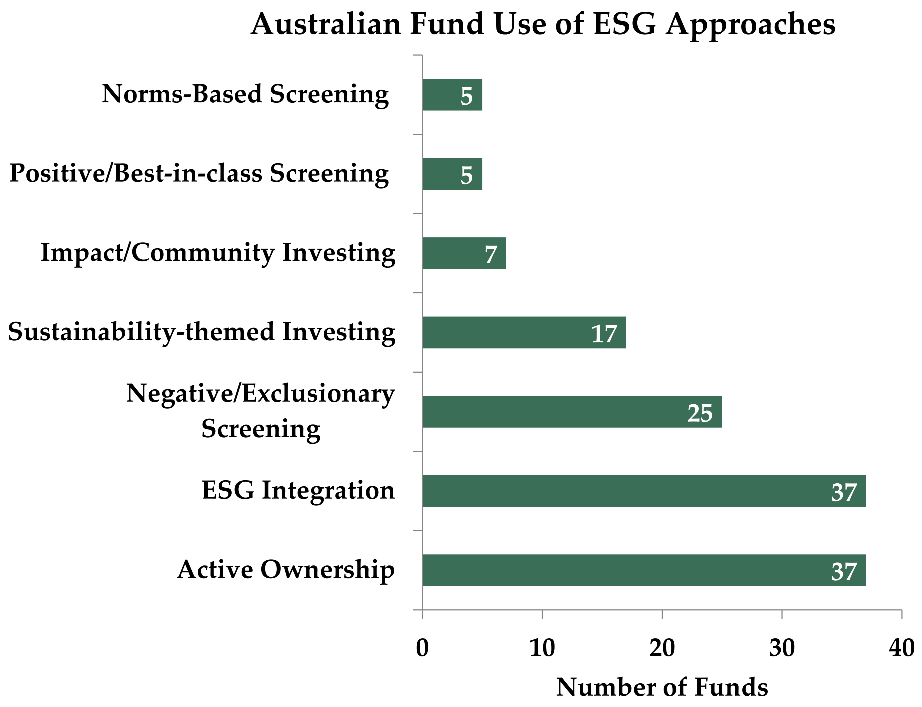
Interest in ESG products is growing rapidly in the United States. Client demand is the primary driver for mangers entering the ESG space, continuing creation of ESG products and the overall growth of the universe. From 1995 through 2016 the US ESG universe had a cumulative growth rate of 1,364 percent. From the beginning of 2014 through to the start of 2016, total US-domiciled assets managed under ESG criteria increased 33 percent, from \$6.57 trillion to \$8.72 trillion.[xiv] US ESG products currently account for more than 1 out of every 5 dollars invested with professional management.[xv] Negative and norms based screenings are the most popular method of U.S. based ESG investing[xvi].

xiv US SIF Foundation, Report on US Sustainable, Responsible and Impact Investing Trends, 2016

xv ibid

xvi ibid

Exhibit 4: Popularity of ESG Approaches Across Top 50 Australian Funds



Source: Superfund Responsible Benchmark Report 2016, Responsible Investment Association Australia

Motivations for US Investors

Motivations for ESG investing within the United States are driven by increasing client demand for advancing ESG principals and by recent legislative changes. US based Institutions with ESG assets include public funds, corporations, educational institutions, foundations, faith-based investors, healthcare funds, labor union pension funds, nonprofits and family offices.

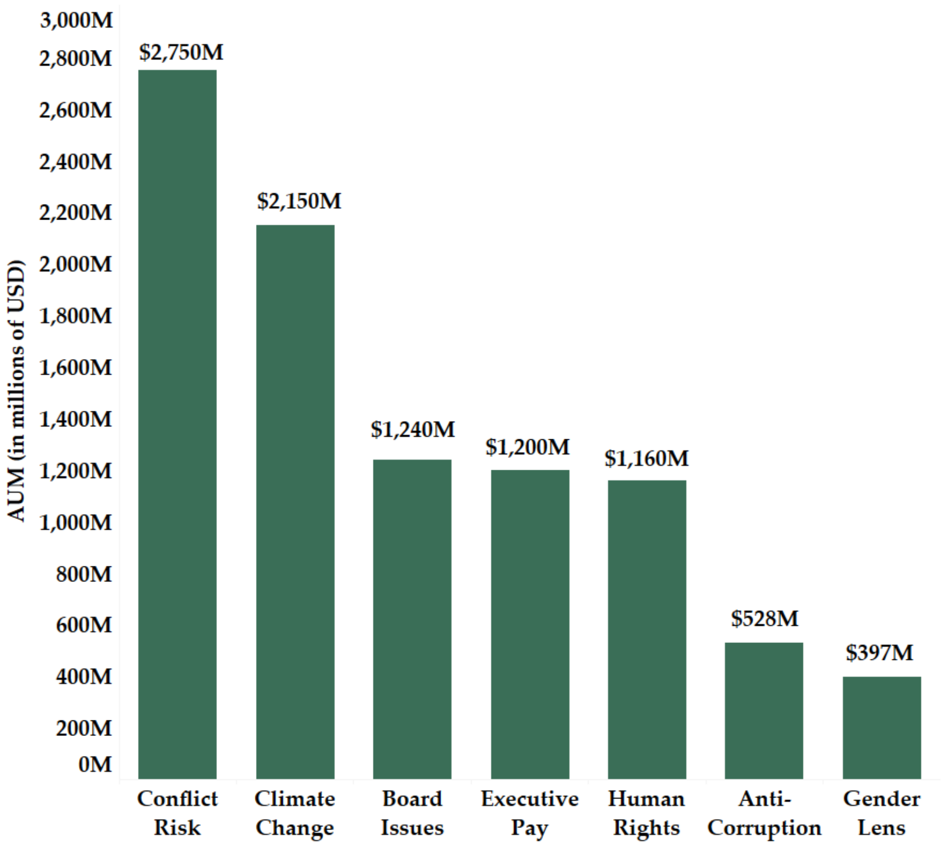
> US ESG products currently account for more than 1 out of every 5 dollars invested with professional management.

The U.S. Department of Labor's (DoL) bulletin of October 2015 clarified how ESG investments are consistent with fiduciary responsibility and facilitated private sector employers adding ESG-fund options to retirement plans. This bulletin helped to dissipate investor concerns over the possibility of breaching fiduciary duty should ESG investments underperform and paved the way for US-defined contribution and benefit plans to take on a larger role in the ESG space.

Motivated by a desire to align their investments with their mission, the Rockefeller Brothers Fund (RBF), made a commitment to begin the process of divesting from fossil fuels in 2014. By December of 2016, RBF had a total of $291.6 million in ESG Investments[xvii] and reduced its exposure to coal and tar sands oil from 1.6 percent in 2014 to 0.1 percent. The largest public pension fund in the U.S.—the Californian Public Employee's Retirement System (CALPERS)— has implemented plans to be fully divested from all companies that receive at least half their revenue from thermal coal by June 2017.

Restricting investments in companies which do business in areas with conflict risk—especially countries with terrorist activities or repressive regimes—is the largest single factor under consideration by US ESG investors, and accounts for $2.75 trillion in assets. Climate change and carbon emission considerations are the second most popular ESG criteria for institutional investors - increasing from $551 billion in 2014 to $2.15 trillion by 2016[xviii] (Exhibit 5).

Exhibit 5: Overview of U.S. ESG Restrictions



Source: US SIF Report on US Sustainable, Responsible and Impact Investing Trends 2016

xvii This includes $191,604,870 in ESG funds and 100,000,000 in impact investments. Source: Rockefeller Brothers Fund website.

xviii ibid

The Future of ESG Asia

Focusing on short term rather than longer term initiatives in addition to the structural socio-economic impediments of specific Asian countries has slowed the adoption of ESG investing in the region.[xix] While Asian ESG markets currently lag those in Europe, the U.S. and Australia, some Asian countries are taking steps to reverse this. Since 2014, Hong Kong, Japan, Malaysia, South Korea, Singapore, Taiwan and Thailand developed stewardship codes aimed at improving engagement between companies and investors are located in Asia.[††††]

> While Asian ESG markets currently lag those in Europe, the U.S. and Australia, some Asian countries are taking steps to reverse this.

Events in Japan over the last few years suggest that the relationship between investors and companies is evolving to take ESG factors into account. Japan's Government Pension Investment Fund (GPIF), the world's largest pension plan with $1.2 trillion in AUM as of December 31, 2015, actively works to fulfill stewardship responsibilities by promoting engagement between its external asset managers and investee companies.[xx] In 2016, GPIF surveyed their external managers about their engagement with the companies within GPIF's fund. They found that more than 60 percent of their fund's companies reported changes in their interactions with GPIF's external managers.

However, Japanese companies and asset managers that are genuinely interested in active stewardship have a hard time differentiating themselves from the short term compliance mentality held by many of their peers. Moving forward, Japanese investors face the decision between simply treating stewardship as a formality or a fundamental shift in their engagement practices with companies.

As stewardship codes are intended to promote corporate governance, shareholder engagement and sustainable growth, over time they should become a catalyst for action. Recently, Taiwan's Bureau of Labor funds, representing $46.7 billion as of July 2016, pledged $2.4 billion (USD) to ESG investments.[xxi] Engaging with companies on ESG issues can be a solution for the wide range of enviromental and social challenges.[xxii] Asian companies with the best sustainability metrics may even begin to have an edge over their competitors. After Sustainalytics launched the channel NewsAsia Sustainability Ranking —which identifies top firms based on ESG metrics across Asian economies—more Asian companies began asking how to improve their ESG scores.[xxiii] Led by India and China, emerging countries are building out a robust green bond market through initiatives aimed at transitioning to a low carbon economy. Moving forward, it remains to be seen if Asian markets will either meet growing ESG interest globally by passively complying or taking an active role in shaping the ESG universe in Asia.

ESG is Here to Stay

Over the past 10 years, global demand—led by institutional investors—for ESG investing has increased dramatically. This growth in demand has spurred the evolution of ESG investing beyond exclusionary screens to include numerous investment approaches such as positive screening, ESG integration and active ownership. Motivations for ESG investing include aligning intuitions values with their investments, addressing key environmental or social challenges, abiding by increasing legal obligations and staying competitive with peer companies. While ESG investing is generally considered standard practices across Europe, current trends indicate it will soon become mainstream in Australia and the United States. The past few years have witnessed higher awareness of ESG factors on the state and company level across Asia. In time, Asian stewardship codes have the potential to both address environmental/social issues and increase the competitiveness of Asian companies in the region. It remains to be seen how investors will change their behaviors to take advantage of these shifting market dynamics because ESG investing is not going anywhere.

xix Principles for Responsible Investment (2016). "The Global Guide to Responsible Investment Regulation"

xx Summary Report of GPIF Stewardship Activities in 2016

xxi 2017 ESG Trends to Watch MSCI

xxii Many residents of Asian countries face heavy air pollution and lack clean drinking water and the availability of water waste treatment.

xxiii Scott, Mike. "Asia's ESG Challenges Present Opportunities for Investors." Financial Times, 2015

† This statistic was taken from the UN Global Compact-Accenture." *UN Global Compact- Accenture Strategy CEO Study – Accenture., 2016,* specfically CEO's mentioned that sustainability--a key ESG factor--was critical to the success of their companies.

†† Expected return methods weigh the anticipated benefits of an investment against its monetary costs. SROI creates a framework to calculate an investment's current social value of impact compared to the financial value of inputs. Theory of change methods design the planned process for achieving social impact, many times with a logic model, a tool that maps the linkages between activities, input, output, outcomes, and eventually the total impact. Mission alignment methods measure the implementation of strategy against the project's mission and end goals over time. It uses rubrics such as scorecards to monitor and manage key performance metrics on organizational effectiveness, operational performance, finances, and social value. Compelling analysis often compares current key performance indicators to a historical starting point, to an original prediction (or to those of industry peers). Experimental and quasi-experimental methods are after-the-fact assessments that use randomized control trials or other counterfactual approaches to determine the impact of involvement compared to the situation if the involvement did not occur. For more information, see Capanyola, Alina, and Ivy So.

††† This weapons category does not take exclusions mandated by law into account. The Anti-Personnel Landmines Convention (1997) and the Convention of Cluster munitions (CM) (2008) facilitated legal requirements to exclude investments in cluster munitions and anti-personal landmines (CM & SPL) in most European countries. Antipersonnel landmines are explosive mechanisms located on or near the ground (for up to years) designed to kill people. Cluster munitions are large weapons that are designed to release dozens to hundreds of sub munitions across a large area.

†††† For example the volume of share repurchases among Japanese companies has increased to JPY 5.1 million as of Sept 2016, up 24% from June 2015, suggesting pressure on companies to raise ROE. At the same time Japan faces a unique challenge of falling human capital with their labor force projected to shrink by 12% in the next 10 years (word for Word MSCI 2017 ESG trends)