European and U.S. Asset Owners' Approaches to ESG

What Investment Managers Need to Know

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The Global Leader in Corporate Solutions & Responsible Investment

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Executive Summary

Incorporating ESG into investment processes now constitutes both a risk management practice *and* an asset-raising strategy for many investment managers. A 2016 Callan Associates study found that 37 percent of U.S. asset owners surveyed incorporate ESG into investment decision making[1]. And in the U.K., 89 percent of RFIs and RFPs contain ESG questions, according to a 2013 report by the U.K.'s National Association of Pension Funds (today named the Pensions and Lifetime Savings Association)[2].

As investment managers consider ways to integrate ESG into current investment processes or launch new products around ESG best practices, they're well served to understand their clients' differing needs, requirements, and approaches on the topic. In this report, ISS compares U.S. and European asset owners' approaches to ESG, with the aim of informing investment managers' evolving strategies. Some key points for managers to consider:

- **By several measures, European asset owners can be viewed as leaders in Responsible Investing (RI),** and a majority of the pension funds across Europe have policies and procedures in place. However, the adoption of RI statements and ESG integration among US public funds is rapidly rising.

- While the European approach to ESG encompasses a long history of screening, exclusions, and shareholder engagement, **practices are evolving and there is no "one size fits all" method.** The lack of an ESG investment regulatory framework in the U.S. is giving rise to a more nuanced discussion on the topic. Both sets of asset owners value disclosure as a way to capitalize on ESG's potential to manage investment and reputational risk.

- **ISS recommends an ESG "toolbox" so that managers can meet both European and U.S. asset owners' evolving ESG needs.** These tools help managers take a norm-based approach to defining and assessing companies' ESG performance- an approach especially prevalent with European asset owners, and growing briskly in the U.S. In addition, controversial weapons, climate impact data, and global sanctions screens enable managers to meet region-specific regulatory requirements around these investments.

An important note: for purposes of this report, when discussing asset owners, ISS focuses mainly on public pension funds. ISS also recognizes that there are inherent flaws in describing "Europe" as a whole and the U.S. as a whole without addressing differences across individual member states. To simplify this analysis, this report compares the most common characteristics across each region.

> As investment managers consider ways to integrate ESG into current investment processes or launch new products around the practice, it is important to understand their clients' differing needs, requirements and approaches on the topic.

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[1] West, Anna S. *2016 ESG Interest and Implementation Survey*, Callen Associates, 2016.
[2] National Association of Pension Funds, *NAPF Responsible Investment Guide 2013*.

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Europe Leads in Responsible Investment

Europe leads in the global investment in Responsible Investment (RI) assets, representing approximately 64 percent of the global mix, according to a 2014 Global Sustainable Investment Review. That's approximately twice the amount of RI assets invested out of the U.S. There are three main reasons behind Europe's leadership in this area:

1. Structurally superior funding status.

According to the European Insurance and Occupational Pensions Authority (EIOPA), the average weighted funded ratio in Europe is in excess of 100 percent, compared to the aggregate 73 percent funded ratio reported by the top 100 U.S. pension funds as of June 30, 2016[34]. Different methodologies impair the direct comparability of funded ratios across regions, but these figures are largely believed to be indicative of the funding gap between the two regions.

Europe's centrally managed, state-funded pensions funds typically finance themselves with tax revenue; this structure helps ease (but certainly not eliminate) funding concerns. As such, this structure may facilitate the longer-term focus that typically defines the ESG investment horizon.

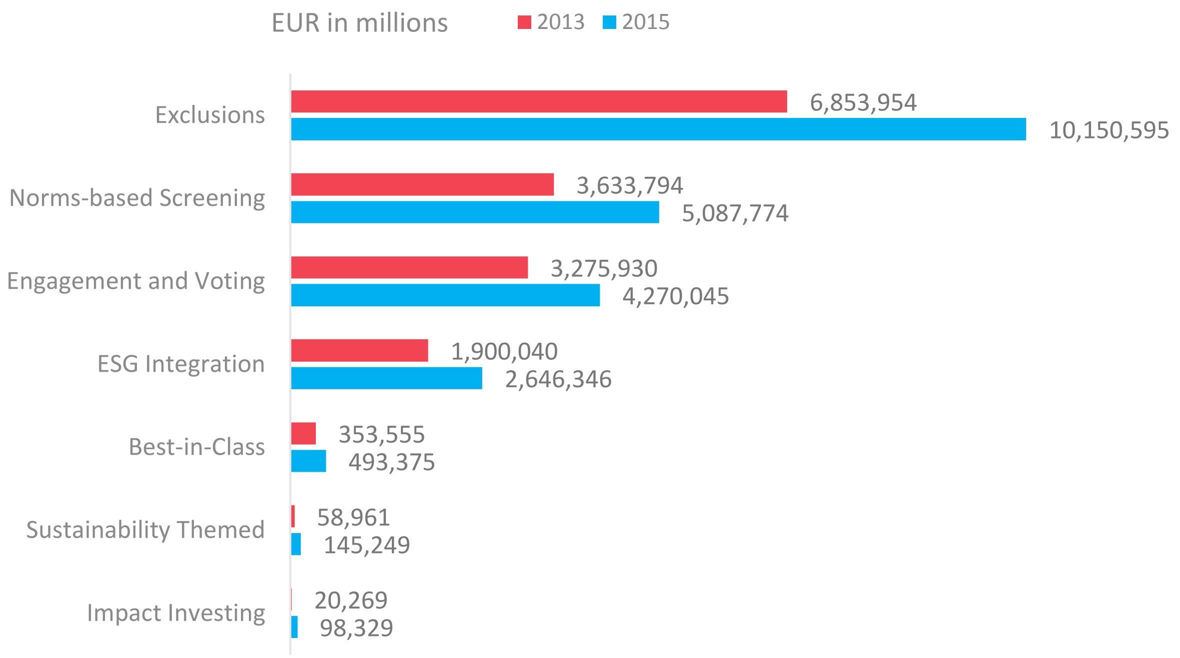
2. History of addressing ESG incorporation based on legal and regulatory frameworks.

European legislation pertaining to pension fund assessment of ESG factors is comprehensive, taking integrational, disclosure, and exclusionary approaches. In 2000, for example, Sweden's state-owned pension funds, the AP funds, became legally required to take environmental and ethical considerations into account without harming the overall goal for high performance. It was on the back of this requirement that ISS-Ethix, in conjunction with a Swedish pension fund, pioneered the norm-based approach (described further below) to assessing companies' ESG performance.

Today, this norm-based approach is the second largest SRI strategy in Europe, as shown in Exhibit 1 below. A recent study by Andreas Hoepner and Lisa Schopohl of the ICMA Centre analyzed the impact of the norm-based screening approach (together with other screening strategies) on the performance of Nordic asset owners' portfolios, and found that excluding companies on this basis "generally does not harm funds' performance."[5]

[3] European Insurance and Occupational Pensions Authority, *Financial Stability Report*, June 2016.
[4] Sielman, Rebecca, *Public Pension Funding Study*, Milliman, September 2016.
[5] Andreas Hoepner and Lisa Schopohl, *On the Price of Morals in the Markets: An Empirical Study of the Swedish AP-Funds and the Norwegian Government Fund*, 3 July 2016.

Exhibit 1: Overview of SRI Strategies in Europe



Source: EuroSIF

In 2000, the UK also enacted legislation that required pension funds to disclose how they incorporate ESG in their investment processes - a good example of a disclosure requirement. In Norway, the Ministry of Finance has the overall responsibility for the $865bn Government Pension Fund Global[6], and has required the Fund to consider ESG and ethical issues since 2002. More recently, France's Energy Transition Law, enacted in early 2016, requires that institutional investors disclose how their ESG approaches align with the country's energy transition strategy. Beyond country-specific approaches, and at the EU level, the newly-approved IORP2 directive puts specific requirements on occupational funds regarding the evaluation of ESG risks.

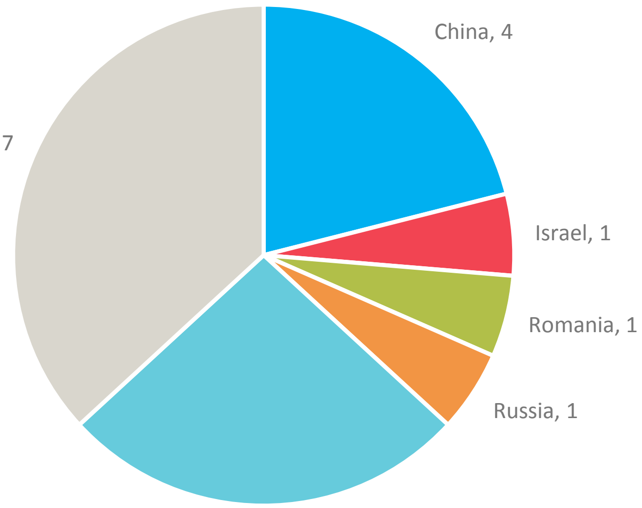
From the perspective of national finance prohibitions, in 2004, Belgium was the first country to introduce a law imposing a general ban on the financing of controversial weapons. The law first addressed anti-personnel mines, and then included cluster munitions and depleted uranium ammunition. Today, Ireland, Italy, Luxembourg, the Netherlands, and Switzerland all have legislation regarding investment restrictions in either cluster munitions and/or anti-personnel mines.

[6] https://www.nbim.no/en/the-fund/about-the-fund/

Companies with verified involvement in anti-personnel mines or cluster munitions

Through ISS-Ethix's internationally recognized Controversial Weapons research, approximately 19 companies are identified as having verified involvement in anti-personnel mines or cluster munitions.

Country of Incorporation of Companies with Verified Involvement in Anti-Personnel Mines and Cluster Munitions



Source: ISS-Ethix, ISS Analytics

3. Cultural differences and societal influences shape RI/ESG within Europe.

Because of the diverse cultural and historical interpretations of the concept of RI and ESG in the different European countries, it is important to highlight that there are more than just one set of definitions of RI/ESG.

For example, according to the 2016 Eurosif SRI Study[7], norms-based screening and engagement strategies are very popular in Scandinavia and Northern Europe, whereas best-in-class and sustainability-themed investments are more common in continental Europe, and voting and stewardship codes are very much embedded in the U.K. investment community. Europe in general has also seen a tremendous push for RI/ESG coming from the media and stakeholders, such as influential NGOs. An example of this is the Dutch television program, Zembla, which, in 2007, claimed that the large Dutch pension funds were invested in cluster bombs, landmines, and child labour. The reaction in the market was strong and resulted in policy and process implementation among the pension funds to consider all of these issues.

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[7] European Sustainable Investment Forum (Eurosif), *European SRI Study*, 2016.

Responsible Investing is Rising in the U.S.

While European asset owners may lead ESG trends, U.S. asset owners are increasingly following suit. Concerns around reputational risk, stakeholder pressures, risk management, and the long-term sustainability of returns press this awareness. In its September 2016 survey of U.S. asset owners, Callan found that 25% percent of public funds used ESG factors in their investments, versus only 15 percent in 2013. Public funds were the asset owner segment with the sharpest increase in ESG adoption in the survey.

Despite this striking growth, the level of adoption is still relatively low in comparison to Europe. In many ways, this reason for this is the inverse of variables discussed in ISS-Ethix's analysis of European asset owners. As indicated in their average 73 percent funding ratio, U.S. public pension funds suffer from chronic underfunding - a condition exacerbated by today's low interest-rate environment. Divergent country histories help explain the vastly different cultural and political approaches to subjects like weapons. And, outside of occasional sanctions for countries like Iran and Sudan, the U.S.' history of exclusionary regulation is comparatively light.

The highly fragmented structure of the U.S. public pension fund system also makes discussion of universal ESG adoption challenging. At a state level, for example, it is not unusual to have separate, distinct funds for public employees, teachers, and public safety workers, with this structure often replicating itself down at the county and city levels.

The result is that there are nearly 4,000 public pension systems in the country, according to a 2013 U.S. Census Bureau study. The complexity of this large and fragmented system makes a centrally managed approach to Responsible Investing immensely difficult. In contrast, in Denmark, a small market where pension funds are required by the Danish government to disclose their RI policy, 100 percent of the occupational pension funds have developed and implemented an RI policy. While U.S. regulator involvement in ESG investment issues remains comparatively light, two regulatory actions enacted in the past 12 months pave the way for broader acceptance of RI approaches among U.S. public funds:

1. The Department of Labor's IB 2015-01, which clarified that plan fiduciaries can use ESG factors as primary factors of economic analysis and/or as tie-breakers; and
2. The SEC's April 2016 concept release for Regulation S-K, in which it identified a series of ESG issues in which investors are seeking more disclosure.

Although many investment managers fear that adopting ESG in their investment process will force divestment, the reality of ESG implementation among U.S. public funds is much more nuanced. Only two large U.S. pension funds have made any fossil fuel divestment commitment, and this commitment may only be partial. Where legislation requiring fossil fuel divestment in the U.S. is enacted, it may give investors mechanisms through which to maintain their holdings. SB185 in California, for example, requires CalPERS and CalSTRS to divest from coal holdings, but defines divestment targets as publicly-traded companies deriving 50 percent or more of their revenue from thermal coal. Furthermore, that legislation requires divestment only if it is consistent with the fund's fiduciary obligations.

A more nuanced, disclosure-driven ESG approach aligns well with U.S. public funds' needs to meet important return targets and work with managers who help achieve them. In general, U.S. public funds seek:

- disclosure from their managers as to how ESG is incorporated into their investment processes, in what part of the process is it considered, what tools are used to identify issues, and how risks are assessed; and
- to understand how these risks fit within the entire investment thesis of holdings (if at all).

Exclusionary Requirements U.S. Public Funds	**Shared Discretionary ESG Objectives**	**Exclusionary Requirements European Public Funds**
Iran/Sudan sanctions	› Monitor reputational risk › Seek ESG disclosure from managers › Risk management › Comply with signatory requirements › Understand fossil fuel exposure	Controversial Weapons

As such, this U.S. approach contrasts with a growing number of European pension funds which, in addition to taking these points into consideration, factor in managers' ESG policy, process, and performance into their fund-selection process.

> Investment managers are well served to consider the full range of tools they can use to manage the increasing expectations from investors, from proxy voting policies, to scoring or screening a portfolio, to solo or pooled engagement with companies on environmental, social, and corporate governance issues. There is no "one size fits all" solution to the variety of requests and requirements public funds may have.

Implications for Investment Managers

Despite the differences in their approaches, U.S. and European asset owners share some common objectives in their ESG approaches. These provide the foundation of a toolbox to support investment managers working with these investors:

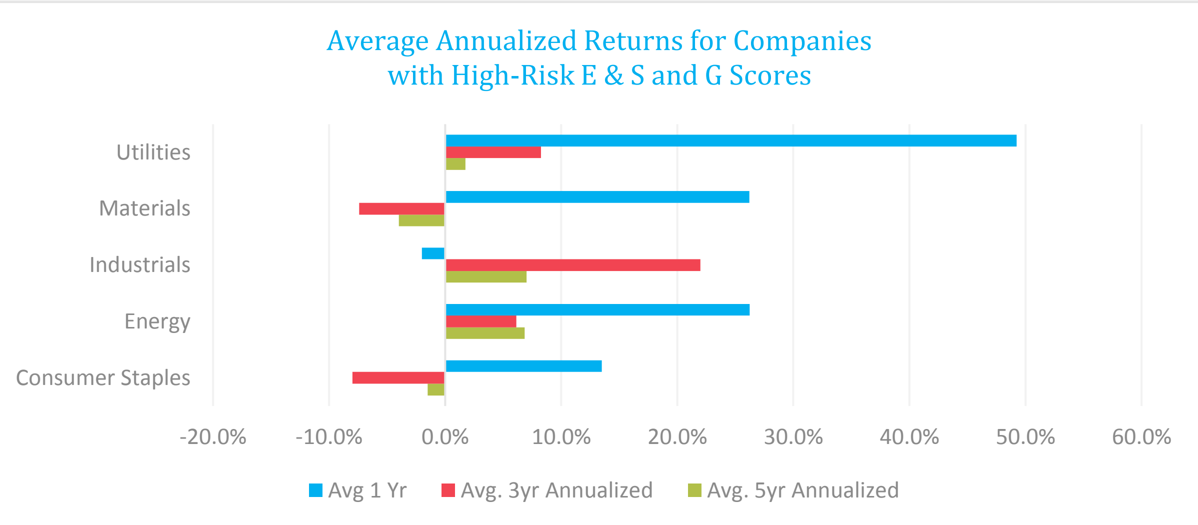
1. ESG as a way to monitor reputational and investment risk.

Ask a European or U.S. asset owner CIO what keeps them up at night, and reputational risk is likely to be part of their answer. Corporate controversies, such as those surrounding headlines like the Dakota Access Pipeline, names like Wells Fargo or Volkswagen, or issues like child labour or corruption, can significantly drain resources and divert attention from asset allocation/investment management. Systematic monitoring of ESG factors can identify potential sources of reputational risk in the total portfolio and in the underlying fund holdings.

Annualized Returns for Companies with High E & S and G Scores

ISS-Ethix pioneered the norm-based approach, and it is now the second largest SRI strategy in Europe. ISS-Ethix' Norm-Based Research identifies some 71 companies worldwide that have "Red" signals based on their performance on Environmental and Social norms.

From a corporate governance perspective, ISS' Governance QualityScore looks at some 5,600 companies worldwide and scores them on a 1 (low risk) through 10 (high risk) basis on their corporate governance attributes. Companies with QualityScores of 8, 9, or 10 can be considered to have higher levels of governance, and thus reputational, risk for both European and U.S. asset owners. Looking across the combined Environmental, Social, and Corporate Governance spectrum, there are 12 companies within the FTSE AllWorld Developed index showing elevated levels of reputational risk.



Source: ISS-Ethix, ISS Analytics

2. Disclosure from investment managers as to their approaches to ESG.

European, and increasingly U.S., asset owners want insights into whether and how ESG is incorporated into managers' investment processes. The starting point for this understanding is often a manager's RI/ESG/policy or mission statement. A holistic policy that fits in well with an investor's overall investment strategy should reflect the manager's thoughtful and nuanced approach to ESG integration.

> ISS-Ethix works with investors worldwide to create RI policies, which are used in both internal guidance and external communication.

3. ISS' proxy voting service allows investors to action ESG viewpoints through a range of standard and custom proxy-voting policies.

In the U.S. ESG investment disclosure focuses mainly on understanding an asset manager's ESG integration process. Asset owners also want to understand risks and their mitigating factors. European investors are more likely to draw a harder line in using ESG integration in their manager selection process and as a basis for an ongoing dialogue with their managers. Some may also take an exclusionary approach, depending on their mission or values.

Both European and U.S. asset owners want to understand the specific ESG data sets used to assess risks. Managers who believe ESG is an innate part of a comprehensive investment process, but who don't have a well-defined process that incorporates ESG-specific data, often face skepticism from asset owners as to the depth of integration. To this end, asset owners and investment managers worldwide use ESG data and research to inform their investment processes. There are many asset owners, particularly in Europe, who may also divest of a company if their engagement attempts with the company are unsatisfactory.

A cohesive ESG approach includes action through proxy voting. Exercising proxy voting rights allows investors to voice a desire for change at a company, and is an alternative to tactics such as divestment.

> ISS' proxy voting service allows investors to action ESG viewpoints through a range of standard and custom proxy-voting policies.

4. Increasing focus on engagement with companies/meeting PRI signatory requirements.

As institutional investors consider the full range of options for encouraging more sustainable corporate practices, engagement through dialogue with companies emerges as a rapidly growing strategy. The importance of engagement in codes such as the PRI further drives the use of this strategy.

Corporate engagement is a resource-intensive activity. Investors need a process for identifying targets for engagement, and they need in-depth knowledge of the enviromental and social issues driving dialogue with management. Collaborating with other investors, conducting follow up, and collecting metrics further challenges those investors embarking on an engagement program.

Services such as ISS-Ethix's Pooled Engagement helps investors meet this challenge. ISS-Ethix's Pooled Engagement service facilitates, on behalf of investors, dialogue with approximately 100 companies a year on a focused set of ESG issues stemming from ISS-Ethix's Norm-Based Research. Investors have the opportunity to opt-out of engagements and receive quarterly and annual reports that track engagement progress. Investment managers who are also PRI signatories use this service to implement the principles and to report on progress. Some investors make services such as this one their central engagement approach; others use it to complement their own engagement activity.

5. Understanding fossil fuel/climate exposure.

As implementation of the Paris Agreement grows, asset owners are paying increasing attention to the risks and opportunities around climate change initiatives.

ISS offers investors a four-pronged approach to understanding their fossil-fuel and climate-change exposure:

- Climate data, analytics, and advisory services that detail climate exposure and align with regulations and initiatives such as France's Article 173, the Montreal Carbon Pledge, and the Task Force for Climate Related Financial Disclosure
- Capturing revenue exposure through screens that identify companies that produce, distribute, and provide services to activities related to fossil fuels and coal mining;
- Research and recommendations on climate-change shareholder proposals, which grew a striking 35 percent and reached an all-time high in the U.S. in 2016; and
- Coverage of climate-change controversies through ISS Ethix's Norm-Based Research.

6. Screen portfolio companies.

From a regulatory and quasi-regulatory perspective, investment managers should also consider three screens as core pieces of their RI toolbox:

- **Controversial weapons screens**
  Many European asset owners have exclusionary requirements around controversial weapons that are aligned with investment belief and with national financing regulation.
- **Iran/Sudan sanction screens**
  In the U.S., sanctions screens around exposure to Iran and Sudan are legislatively required by about 25

states. State-specific screens help investors meet each state's nuanced requirements for capturing this exposure.

- **Tobacco screens**
  Tobacco screens are ubiquitous among asset owners on both sides of the Atlantic. Although there is seldom a regulatory requirement around these screens, sensitivity to the issue is widespread enough that asset owners seek to limit exposure to the sector. Typically this limitation is implemented by excluding companies with a defined revenue exposure to the production, distribution, or marketing and promotion of tobacco products.

ISS-Ethix Delivers a Complete Solution to Screen, Research and Analyze Company Performance

ISS-Ethix offers a wide range screening tools, employed by institutional shareholders in company engagements globally, regionally and in emerging markets. ISS-Ethix leverages its industry-leading expertise to help investors meet asset owner requirements for controversial weapons, which is common in Europe. Companies are assigned a red, amber, or green flag based on a well-established methodology that assesses direct or indirect involvement in the development, production, maintenance or sale of weapons that are illegal—as prohibited by international legal instruments—or deemed controversial because of their indiscriminate effects and the disproportionate harm they cause.

Investors seeking more information on controversial weapons should see ISS' report, *Cluster Munitions, Anti-Personnel Mines, and Biological, Chemical, and Nuclear Weapons: Where They are Still in Production, Who is Making Them, and What is Next*.

For Iran and Sudan sanctions, ISS-Ethix screens about 8,500 large, mid, and small cap companies worldwide to identify and dynamically update companies' equity and non-equity exposure to these countries. Investors seeking to better understand the current state of U.S. sanctions on Iran should see ISS' paper, *The Iran Nuclear Deal: Iran Sanctions Create a Complex Outlook for Investors Looking to Comply with U.S. State-level Sanctions Requirements*.

In addition, ISS-Ethix screens more than 8,500 companies worldwide for tobacco exposure, and allows investors to customize the level of revenue exposure for which they want to set a tobacco screen.

Table 1: Responsible Investment Toolbox for Investment Managers

Type of Asset Owner	ESG Objective	ISS Solutions to Help Investment Managers Respond
U.S., European asset owners	Understand how external managers use ESG factors in investment process	› RI mission statements/policies › Norm-Based Research for insights on E&S risks › Governance QualityScore for insights on corporate governance risks
U.S., European asset owners	Actioning E, S, and G viewpoints	› Sustainability and custom proxy voting policies › Pooled engagement on E&S issues
European asset owners	Comply with regulatory exclusion requirements around controversial weapons, and other requirements	› Controversial weapons screens › Sector screens such as tobacco and arms
U.S. asset owners	Comply with regulatory exclusion requirements around state-specific Iran/Sudan sanctions, and common tobacco exclusion requirements	› Iran/Sudan screens › Tobacco screens

The solutions provided by ISS-Ethix form a foundation in meeting the most common asset owner requirements around ESG issues. Investment managers may face additional requirements from asset owners that represent mission-centered, faith-based, union, or trade funds, as well different requirements unique to different public funds. In addition to RI policy development support, Pooled Engagement services, specialized proxy voting approaches, and Norm-Based Research, ISS provides investors with a full suite of screens that meet various asset owners' needs.

Get started on ISS-Ethix.

Email sales@issgovernance.com or visit www.issgovernance.com/esg for more information.

ABOUT ISS

Founded in 1985 as Institutional Shareholder Services Inc., ISS is the world's leading provider of corporate governance and responsible investment (RI) solutions for asset owners, asset managers, hedge funds, and asset service providers. ISS' solutions include: objective governance research and recommendations; RI data, analytics, and research; end-to-end proxy voting and distribution solutions; turnkey securities class-action claims management (provided by Securities Class Action Services, LLC); and reliable global governance data and modeling tools. Clients rely on ISS' expertise to help them make informed corporate governance decisions. For more information, please visit www.issgovernance.com.