Principles for Responsible Investment

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

LISTED EQUITY

OVERVIEW

- This starter guide provides a quick summary of how an investor can manage environmental, social and governance (ESG) issues in listed equity portfolios.
- It outlines options for how to include ESG issues when building an equity portfolio and when working with companies on how they manage ESG issues.
- Selected further reading is provided throughout. For more information on anything in this guide, or responsible investment more broadly, please get in touch.

The PRI defines responsible investment as a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership.

It complements traditional financial analysis and portfolio construction techniques.

AN INTRODUCTION TO
RESPONSIBLE INVESTMENT

EXPLORE THE SERIES

This guide will take you through the following approaches to managing ESG issues in listed equities:

<table>
<tr><th colspan="3">CONSIDERING ESG ISSUES WHEN BUILDING A PORTFOLIO
(known as: ESG incorporation)</th><th colspan="2">IMPROVING INVESTEES' ESG PERFORMANCE
(known as: active ownership or stewardship)</th></tr>
<tr><td colspan="3">ESG issues can be incorporated into existing portfolio construction practices using a combination of three approaches: integration, screening and thematic.</td><td colspan="2">Investors can encourage the companies they are already invested in to improve their ESG risk management or develop more sustainable business practices.</td></tr>
<tr><th>Integration</th><th>Screening</th><th>Thematic</th><th>Engagement</th><th>Proxy voting</th></tr>
<tr><td>Explicitly and systematically including ESG issues in investment analysis and decisions, to better manage risks and improve returns.</td><td>Applying filters to lists of potential investments to rule companies in or out of contention for investment, based on an investor's preferences, values or ethics.</td><td>Seeking to combine attractive risk-return profiles with an intention to contribute to a specific environmental or social outcome. Includes impact investing.</td><td>Discussing ESG issues with companies to improve their handling, including disclosure, of such issues. Can be done individually, or in collaboration with other investors.</td><td>Formally expressing approval or disapproval through voting on resolutions and proposing shareholder resolutions on specific ESG issues.</td></tr>
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CONSIDERING ESG ISSUES WHEN BUILDING A PORTFOLIO (ESG INCORPORATION)

ESG issues can be incorporated into listed equity investment strategies using three approaches: integration, screening and thematic. Investors select between, or combine, these approaches based on their desired outcomes. This may be to enhance their risk-return profile, avoid specific companies or sectors, or drive capital towards particular environmental and/or social goals.

The actions investors take to include ESG issues when building a portfolio are covered by Principle 1 of the six Principles for Responsible Investment: "We will incorporate ESG issues into investment analysis and decision-making processes."

Comparing key characteristics of ESG incorporation approaches in listed equity

	INTEGRATION	SCREENING	THEMATIC
Provides a more complete picture of the risks and opportunities faced by a company	●		
Is applicable to investors that have no interest in considerations outside of their risk-return profile	●		
Can fit within existing investment processes	●	●	●
Restricts investment in certain industrial sectors, geographic regions or individual companies, typically for ethical reasons		●	●
Non-financially material ESG factors or ethical considerations are incorporated into investment decisions		●	●
Directs capital towards investments that contribute to environmental or social outcomes			●

This table gives a broad overview of some of the differences between the major types of ESG incorporation. It is not a detailed or exhaustive classification.

WORKING ACROSS THE ACTIVE-TO-PASSIVE SPECTRUM

While ESG incorporation is often associated with active strategies, passive strategies can also take ESG issues into account.

ESG incorporation in listed equity across the active-to-passive spectrum

ACTIVE → PASSIVE

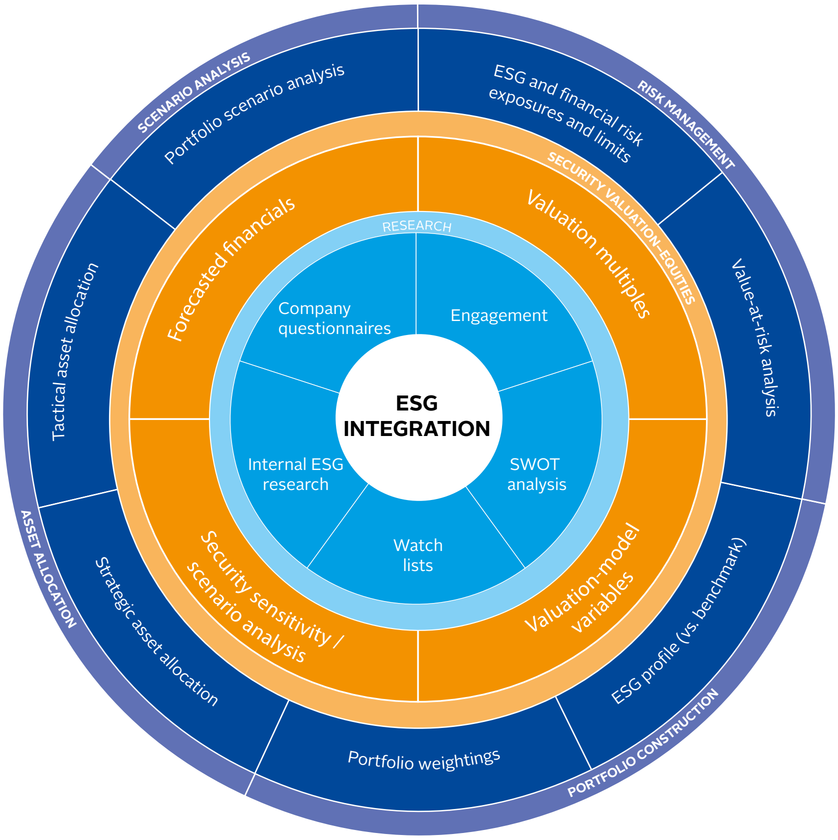
	INVESTMENT APPROACH		
INCORPORATION APPROACH	**FUNDAMENTAL ANALYSIS**	**QUANT AND SMART BETA**	**INDEX INVESTING**
Integration	ESG factors are integrated into absolute and relative valuation models alongside all other material factors. Investors can adjust forecasted financials (such as revenue, operating cost, asset book value and capital expenditure) or company valuation models (including the dividend discount model, the discounted cash flow model and adjusted present value model) for the expected impact of ESG factors.	ESG factors can be integrated into quantitative models alongside factors such as value, quality, size, momentum, growth and volatility. ESG factors and scores can be used as a weight in smart beta portfolio construction to contribute to excess risk-adjusted returns, reduce downside risk and/or enhance portfolios' ESG risk profile.	Material ESG issues are identified and translated into rules that feed into portfolio construction, alongside traditional factors. The overall ESG risk profile, or exposure to a particular ESG factor, can be reduced by adjusting index constituent weights or by tracking an index that already does so.
Screening	Filters are applied to lists of potential investments, ruling companies in or out of contention for investment based on an investor's preferences, values or ethics. Filters are typically based on including or excluding particular products, services or corporate practices.		
Thematic	Companies that meet valuation and financial thresholds – and address sustainability challenges and themes – are identified for investment. Includes impact investing.		Indices that focus entirely on environmental and social themes – such as clean technology, climate change, microfinance – are selected for investment.

INTEGRATION: ADDING ESG FACTORS TO FINANCIAL ANALYSIS

Material ESG factors are identified and assessed alongside traditional financial factors when forming an investment decision about a specific company or the overall portfolio structure, to lower risk and/or enhance returns. Investors apply a range of techniques to identify risks and opportunities that might remain undiscovered without the analysis of specific ESG data and broad ESG trends.

Integration typically has three steps:

- **Security research**: Identifying material ESG issues that impact equity valuations (or provide topics for engagement).
- **Security valuation**: Integrating the material ESG issues into financial analysis and valuation, e.g. by making adjustments to required rates of return, valuation multiples, forecasted earnings, cash flows and balance sheet strength.
- **Portfolio management**: Including the ESG analysis in decisions about portfolio construction, e.g. through sector weightings.



Click here for a full version of the ESG integration framework

PRI resources:

Guidance and case studies for ESG integration: equities and fixed income

ESG integration in Europe, the middle East, and Africa: markets, practices and data

ESG integration in the Americas: markets, practices and data

ESG integration in Asia Pacific: markets, practices and data

A practical guide to ESG integration for equity investing

How can a passive investor be a responsible investor?

Top academic resources on responsible investment

SCREENING: FILTERING THE INVESTABLE UNIVERSE

Screening uses a set of filters to determine which companies, sectors or activities are eligible or ineligible to be included in a portfolio based on an investor's preferences, values and ethics. For example, a screen might be used to exclude the highest carbon emitters from a portfolio, or to target only the lowest emitters. ESG scores can be obtained from specialist ESG service providers, or by creating a proprietary scoring methodology.

NEGATIVE SCREENING Avoid the worst performers	**NORMS-BASED SCREENING** Use an existing framework	**POSITIVE SCREENING** Include the best performers
Excluding certain sectors, companies or projects for poor ESG performance relative to industry peers, or based on specific ESG criteria, e.g. avoiding particular products/services or business practices.	Screening investments against minimum standards of business practice based on international norms. Useful frameworks include UN treaties, Security Council sanctions, UN Global Compact, Universal Declaration of Human Rights and OECD guidelines.	Investing in sectors, companies or projects selected for positive ESG performance relative to industry peers.

THEMATIC: ALLOCATING CAPITAL TOWARDS ENVIROMENTAL OR SOCIAL OUTCOMES

Thematic investing identifies and allocates capital to themes or assets related to certain environmental or social outcomes, such as clean energy, energy efficiency or sustainable agriculture.

Impact investing is a subset of thematic investing that aims to ensure that investments lead to *additionality* of impact – meaning a social or environmental outcome would not have been achieved without that particular investment. It also requires adequate measuring and monitoring of the investment's impact on environmental or social outcomes.

PRI resources:

Impact investing market map

IMPROVING INVESTEES' ESG PERFORMANCE (ACTIVE OWNERSHIP OR STEWARDSHIP)

The actions investors take to encourage the companies they are already invested in to improve their ESG risk management or develop more sustainable business practices is covered by Principle 2 of the six Principles for Responsible Investment: "We will be active owners and incorporate ESG issues into our ownership policies and practices."

Investors can use their position (and legal rights) as partial owners of companies to influence a) what activities those companies engage in, and b) how they behave and operate. Through this process – known as active ownership or stewardship – active or passive investors can encourage companies to:

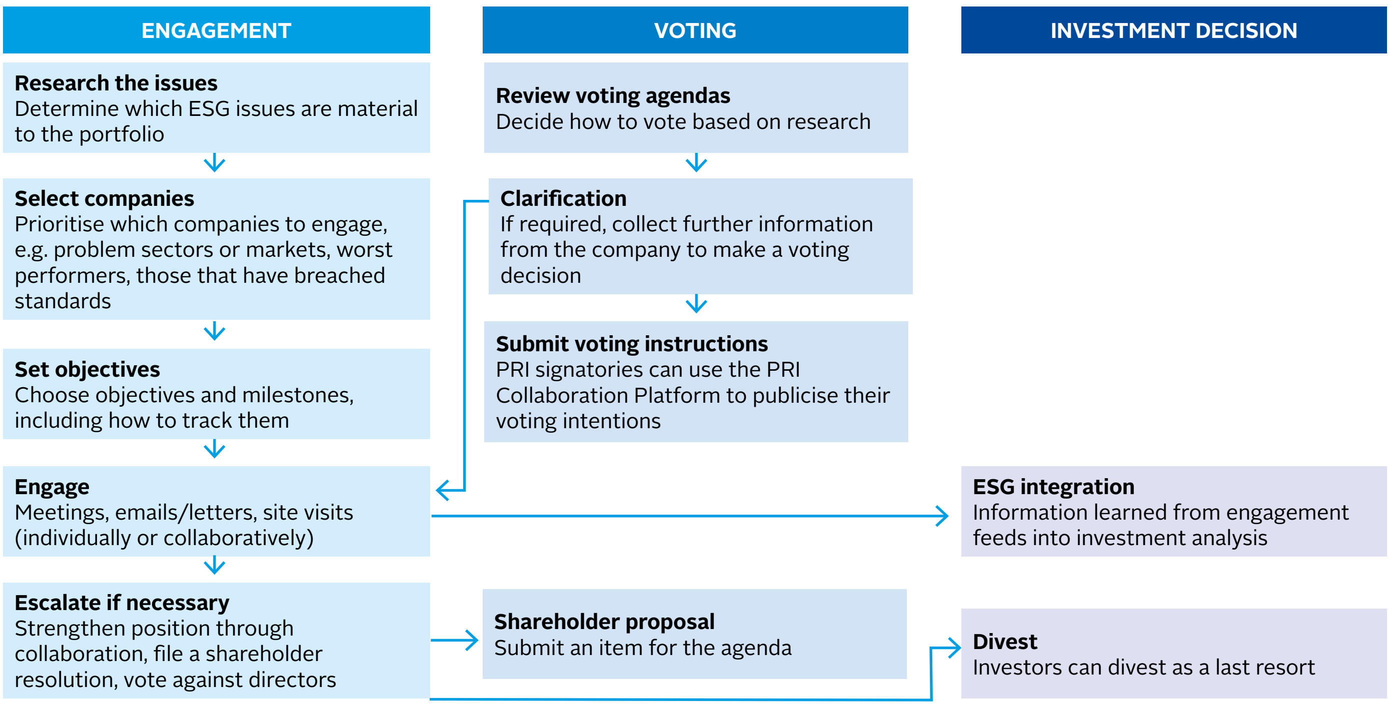
- better manage material ESG issues to minimise risks and maximise performance;
- increase the quality of information they disclose on ESG issues, allowing investors to make more informed decisions;
- improve corporate practices to promote financial or non-financial objectives.

An initial step is to publish a policy outlining the investor's overall active ownership approach, the priority issues, plans for reporting and views on escalation. This is particularly important if engagement is outsourced.

Investors should consider not only ESG risks and opportunities that are relevant to individual companies, but also long-term risks that affect the whole portfolio, such as climate change.

Engagement, voting and investment decisions feed into each other. Research that is carried out for engagement can also be used to determine voting decisions. Alongside voting, investors can file shareholder resolutions to escalate an issue if engagement is unsuccessful. As a last resort, an investor may choose to divest or take legal action against the company or its board.

Interaction between engagement, voting and investment decision



PRI resources:

A practical guide to active ownership in listed equity

Responding to megatrends: Investment institutions trend index 2017

PRI Collaboration Platform

ENGAGEMENT: WORKING WITH COMPANIES

Engagement sees investors working with investee companies to improve how they are managing or disclosing ESG performance. It can be a proactive attempt to address something the investor's own research and analysis has highlighted, or a reactive move, such as in response to a controversial event.

Investors can engage individually, in collaboration with other investors (including across asset classes), or through an outsourced engagement service provider. Engagement typically involves private meetings or letters between investors and companies, but can also involve dialogue at the company AGM, or in other shareholder meetings such as during earnings calls or roadshows.

Academic research commissioned by the PRI[1] shows that successful engagement can contribute to better corporate financial performance, improved shareholder returns and strengthened relationships between investors and companies.

Good engagement requires identifying relevant ESG issues, choosing a company or group of companies to engage, setting objectives, tracking results and feeding those results back into investment decision making. Persistence, consistency and listening are key.

If initial engagement efforts are unsuccessful, investors can consider escalation strategies such as collaborating with other investors, contacting the board, issuing a public statement, voting against directors, filing a shareholder resolution, seeking legal remedies, reducing exposure or divesting. Divestment is typically seen as a last resort, and passive investors will not be able to reduce exposure or divest unless they exit the index entirely, or adjust weightings if using a tailored index.

PRI resources:

Outcome reports from collaborative engagements coordinated by the PRI

VOTING: HOLDING MANAGEMENT TO ACCOUNT

Voting practices have long been a central part of how investors can express concerns over governance issues such as board pay and director appointments, but resolutions proposed by shareholders increasingly relate to social and environmental issues as well.

Voting involves research, casting votes and communicating with investee companies before and after the AGM. It is also regarded as good practice to explain to the company the reasons for any votes against management or voting abstentions. Public reporting of voting decisions is also increasingly common.

While outsourcing voting activities to proxy advisors is essential for investors that hold thousands of companies, responsible investors dedicate time and resources towards ultimately making their own informed decisions, rather than automatically acting on their advisor's recommendations.

FURTHER READING

For a list of resources on responsible investment in listed equity from other organisations, visit the PRI website.

1 How ESG engagement creates value for investors and companies; Local leads, backed by global scale: the drivers of successful engagement

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