Principles for Responsible Investment

ASSET OWNER TECHNICAL GUIDE

INVESTMENT MANAGER SELECTION GUIDE

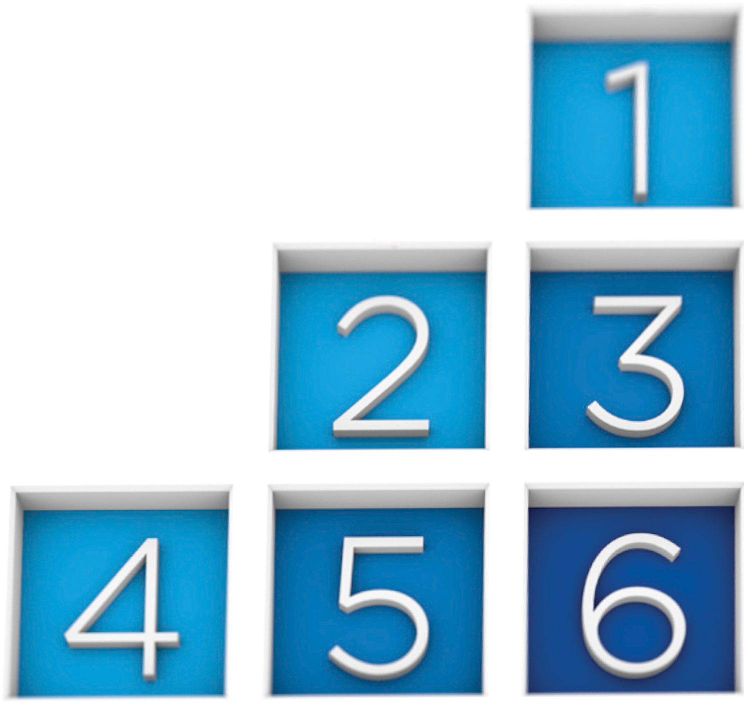
FINANCE UNEP INITIATIVE
United Nations Global Compact
An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.



PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

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EXECUTIVE SUMMARY

The incorporation of ESG factors within the investment process has evolved from a nice-to-have to a necessity. Client demand has grown strongly, with 68% of the PRI's asset owner signatory base addressing ESG considerations in their requests for proposals (RFPs).[1]

This means that many asset owners expect investment managers to include financially material ESG factors within their funds and investment strategies. In addition, policy makers around the world are introducing regulatory requirements for both investment managers and asset owners to disclose and report on responsible investment practices.[2]

THE PRI LEADERS' GROUP

The PRI has identified [The PRI Leaders' Group 2019](), which highlights the asset owner leaders that have a thorough and systematic process for investment manager selection.

The PRI believes that responsible investment principles should be at the core of the relationship between the asset owner and the investment manager. To reflect their importance, they should be incorporated into all stages of the investment manager selection process.

The PRI has produced guidance to help asset owners address responsible investment principles and ESG factors in their relationships with their investment managers. The guidance comprises five modules (see Figure 1). They should be read in conjunction and will act as road map for asset owners to thoroughly embed ESG issues in their investment processes and at the core of the relationship between them and investment managers.

Module 1 describes a process followed by an asset owner to develop a responsible investment policy and strategy. This also includes the development of a strategic approach to asset allocation that incorporates ESG considerations.

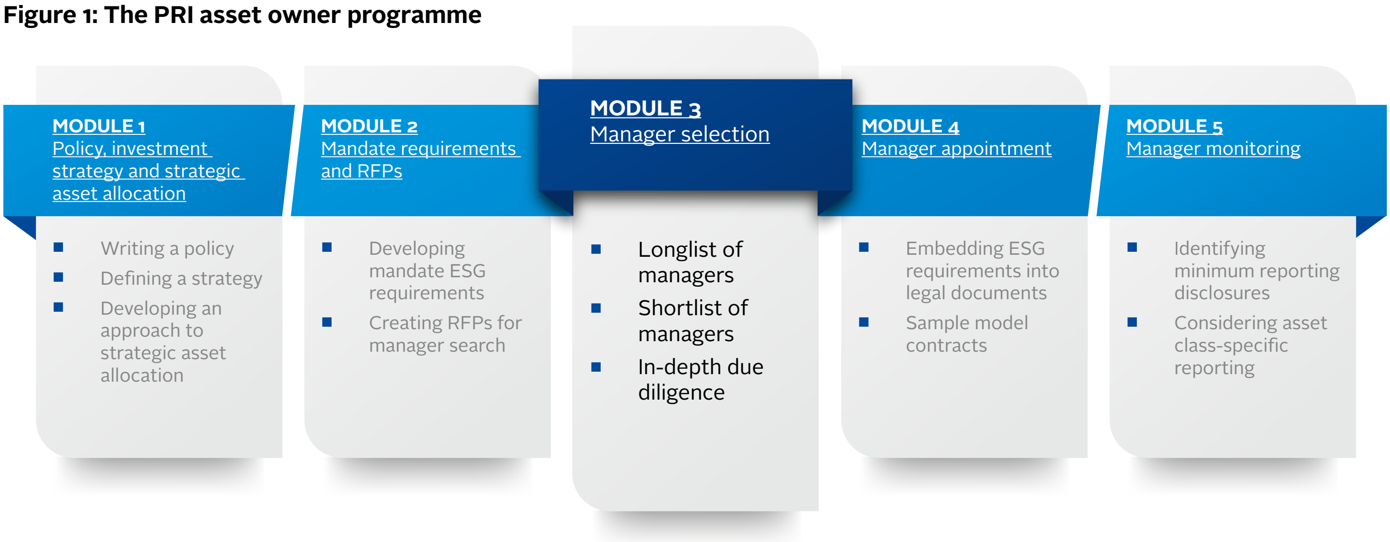
Module 2 addresses the internal process of establishing mandate requirements, including key ESG considerations that will govern the investment manager, and drafting the RFP to reflect those requirements at a high level.

Module 3 focuses on the manager selection process to identify the investment manager that has the responsible investment attributes in place to meet the ESG requirements specified by the asset owner in Module 2.

Module 4 describes the manager appointment process to transfer the requirements specified in the mandate into legal documentation.

Module 5 sets out a harmonised approach to investment manager monitoring, including tools and practical recommendations.

Figure 1: The PRI asset owner programme



1 Source: PRI 2019 Reporting and Assessment Framework results.

2 See more on the PRI's [Responsible investment regulation map]()

As identified in this technical guide and to feed into a comprehensive decision-making process, an asset owner should identify a manager which:

- is aligned with its investment principles and beliefs;
- systematically integrates ESG factors into investment decisions;
- analyses ESG materiality before and after investment decisions;
- acts as a good steward and implements responsible investment and engagement practices;
- addresses positive and negative outcomes caused by its investments; and
- undertakes adequate public/transparent disclosure and implements appropriate accountability mechanisms.

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PRI ASSET OWNER ADVISORY COMMITTEE

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- Xander den Uyl, Stichting Pensioenfonds ABP (Chair)
- Douglas Chau, University of Toronto Asset Management Corporation
- David Russell, USS

CONSULTATION PARTICIPANTS

- Andrea Ximena Pineda Perez, Afore XXI Banorte
- Elda Nohemi Navarro Salas, Afore XXI Banorte
- Gabriela Lizette Luna Zambrano, Afore XXI Banorte
- Soňa Stadtelmeyer-Petrů, Allianz SE
- Dr. Frank Pfeuffer, Allianz SE
- Tina Rönnholm, AP1
- Anna Follér, AP6
- Liza McDonald, Aware Super
- Amy Krizanovic, Aware Super
- Aaron Pinnock, Church Commissioners for England
- Joonas Huttunen, The Church Pension Fund, Finland
- Cristian Hidalgo, Cuprum afp
- Mari Murata, GPIF
- Jeremy Tan, Local Government Superannuation Scheme
- Moya Yip, Local Government Superannuation Scheme
- Venn Purnell, Local Government Superannuation Scheme
- Diandra Soobiah, NEST
- Eri Yamaguchi, New York State Common Retirement Fund
- George Wong, New York State Common Retirement Fund
- Adriana Sierra Angel, Proteccion SA
- Maria Cristina Ramirez Patiño, Proteccion SA
- Sandra Susana Gutiérrez Guzmán, Proteccion SA
- Anna Yildiz-Doukakis, Swiss Re Ltd
- Claudia Bolli, Swiss Re Ltd
- Dennis Turton, Trust Waikato
- Maggie (Shengnan) Zhang CA, Trust Waikato
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- Vesa Syrjäläinen, Varma Mutual Pension Insurance Company

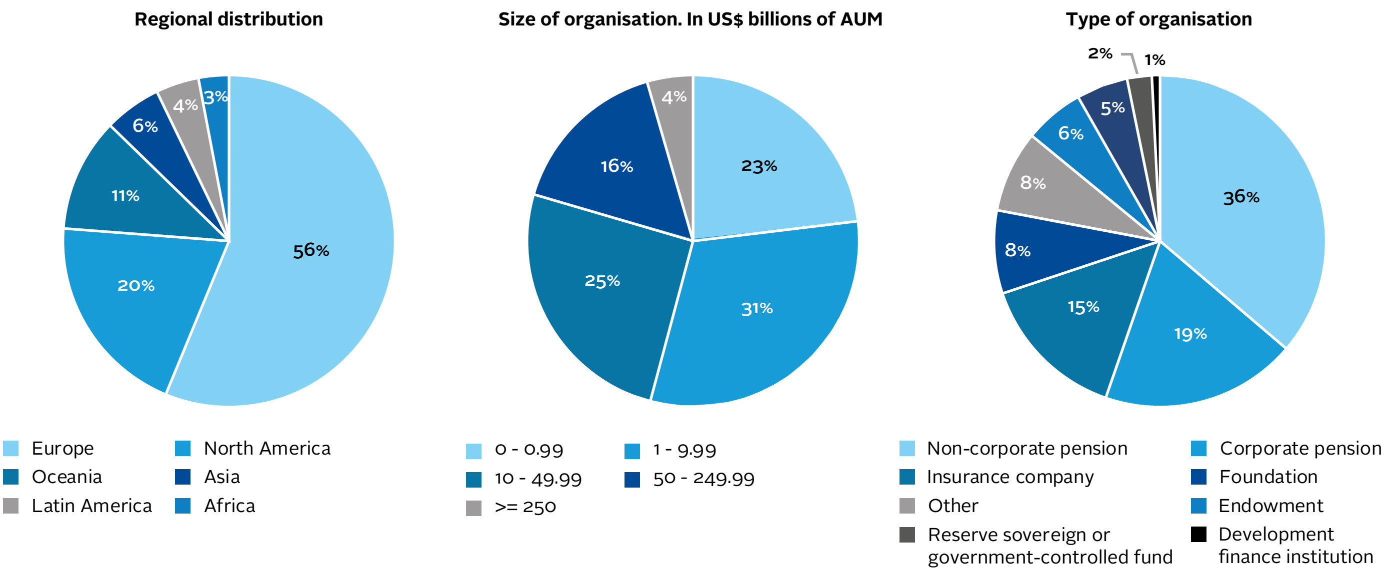
ABOUT THIS GUIDE

This guide aims to support asset owners in their investment manager selection process. It follows a three-step process, covering longlisting, shortlisting and in-depth due diligence. For each step, the guide provides frameworks and indicative lists of leading practices that asset owners can use and adjust according to their specific needs. It is therefore intended to complement existing procedures rather than replace them.

The guide has been developed based on desk research, a review of current industry guidance from the PRI and third-party sources, and both public and confidential information provided by PRI signatories through a number of channels. These include discussions at an asset owner roundtable event during the PRI in Person conference in 2019, practices set out in the PRI Leaders' Group 2019 publication,[3] and a review of responses to the PRI's Reporting and Assessment Framework in 2019.[4] This latter examined responses from 379 asset owner signatories (see Figure 2).

These information sources have revealed leading practices from an array of asset owners around the world, which have been referenced on a non-attributable basis. All figures and tables are based on public or confidential information provided by PRI signatories, and individual references are omitted for compliance purposes.

Figure 2: PRI asset owner signatory base, 2019



It is important to recognise that asset owners may partly or fully outsource their selection processes to a third party. The PRI publication [Investment consultants and ESG: An asset owner guide](), examines the role of the consultant in various elements of investment management, and suggests due diligence questions for the asset owner to ask the investment consultant when establishing a relationship or for monitoring purposes.

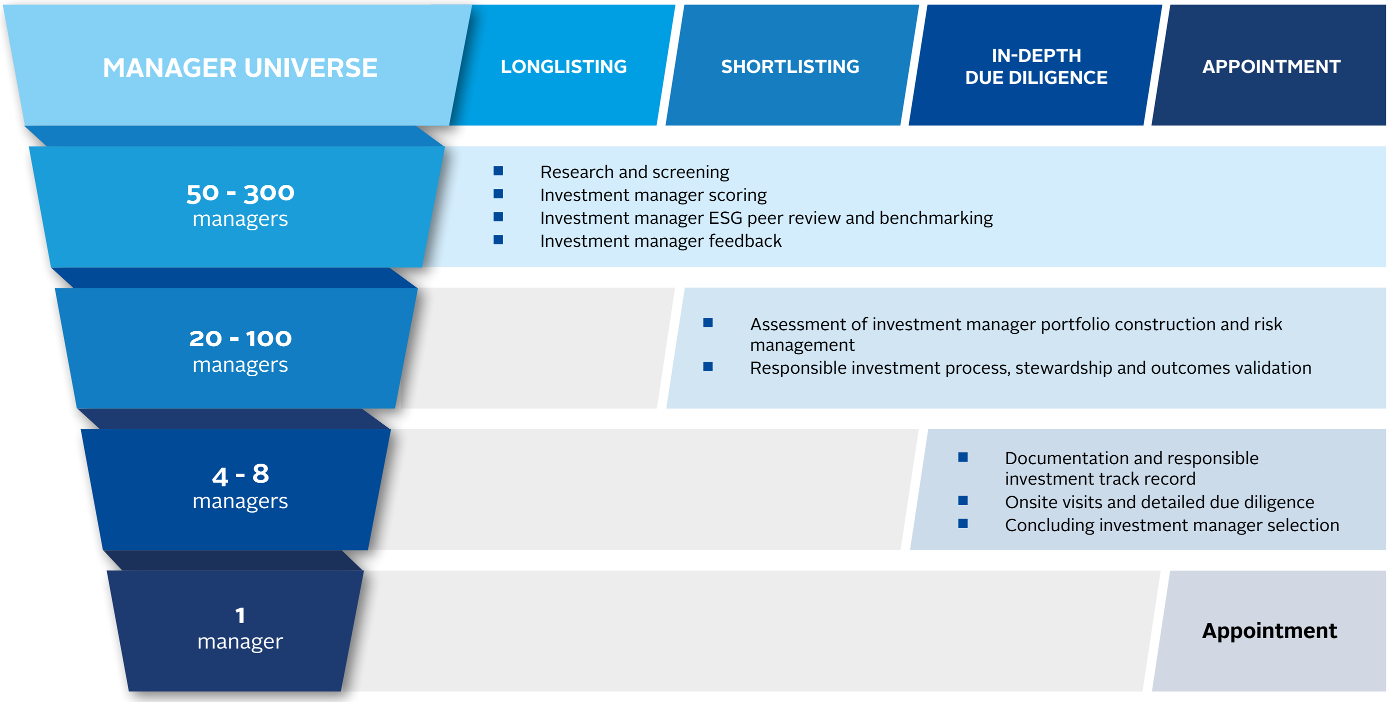
This guide was produced as part of the PRI's programme to support asset owners in their implementation of the PRI's six principles and their efforts to help build a sustainable financial system. It is equally relevant for investment consultants and fund-of-fund managers tasked with investment manager selection. Investment managers might find this guide useful in preparing themselves for requests from their client base. The leading practices identified within this guide could be adopted by the industry as a whole and are not limited to PRI signatories. The PRI anticipates updating this guide in future as market practice evolves.

3 PRI (2019), The PRI Leaders' Group 2019

4 In addition, the PRI reviewed signatory responses to the 2020 PRI's Reporting and Assessment Framework as a sense check. This group comprised 661 reporting entities, including 381 asset owner organisations.

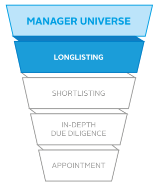
MODULE 3:
ASSET OWNER – MANAGER SELECTION

Figure 3: The investment manager selection process



The purpose of the manager selection process from an ESG perspective is to identify an investment manager that has the people, process and expertise in place to meet the ESG requirements specified by the asset owner in the investment mandate (see Module 2).

Figure 3 sets out the investment manager selection structure proposed in this guide. It consists of three steps: longlisting of investment managers; shortlisting of investment managers; and in-depth due diligence.



LONGLISTING OF INVESTMENT MANAGERS

This section covers research into and the scoring and screening of investment managers. It sets out high-level frameworks an asset owner might apply to carry out manager selection. It also covers topics such as culture, governance, sources of data, benchmarking and feedback.

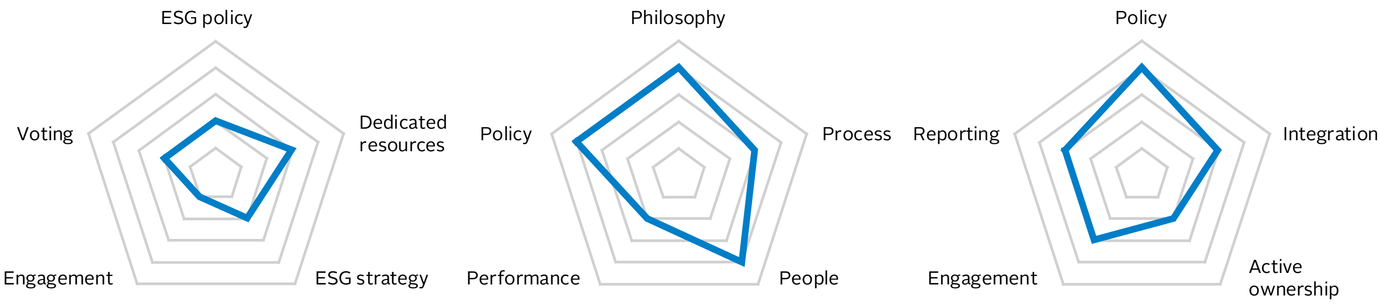
RESEARCH AND SCREENING

As the first step in selecting a potential investment manager, an asset owner will have to address the mandate specification laid out in the request for proposal (RFP) to assess the manager against those qualifying criteria. Within the RFP, the asset owner might stipulate the ESG practices that an investment manager should apply. To evaluate these ESG practices, asset owners use assessment frameworks which can vary across asset classes and according to the asset owners' investment principles and beliefs.

In order to build a common understanding of those practices across the asset owner's organisation, ownership of the investment manager selection process could be a shared responsibility for the investment team, risk management and the ESG specialist.

Figure 4 shows indicative examples of assessment categories applied by PRI asset owner signatories. The PRI Reporting and Assessment Framework provides general definitions for some of the categorisations.

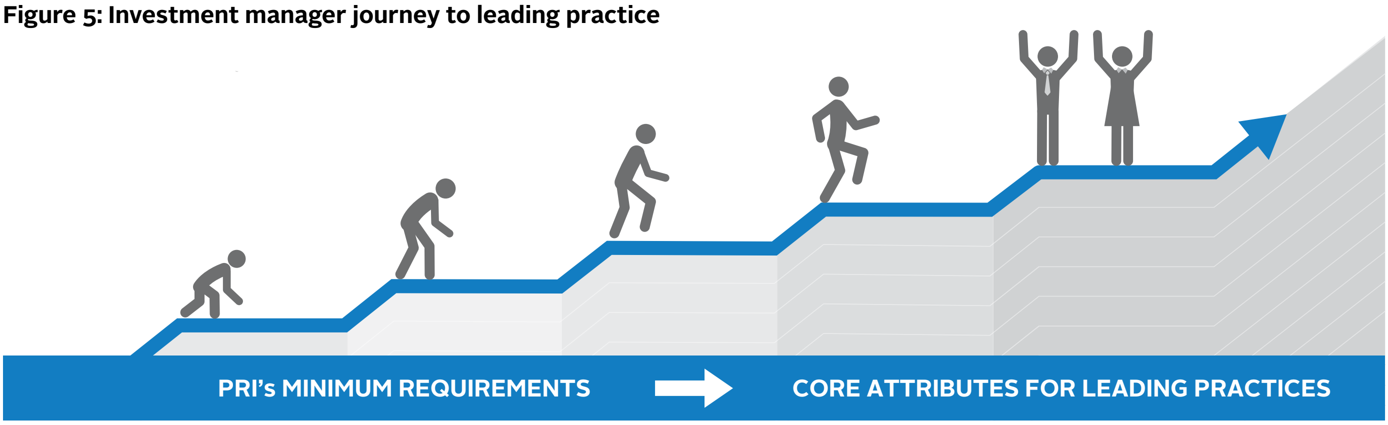
Figure 4: Practical examples of responsible investment manager assessment frameworks. Source: PRI. Anonymised examples provided by PRI signatories through the 2019 Reporting and Assessment Framework. Scoring in different categories does not represent actual performance and is presented for illustrative purposes only.



To encourage investment managers to adopt leading practices, the PRI showcases two frameworks that could aid an asset owner in an initial classification. The PRI has outlined a set of minimum requirements for signatories covering various aspects of policy and process.[5]

This guide also identifies a set of core attributes for leading practices; these are an amalgamation of practices assessed by the PRI's asset owner signatories.

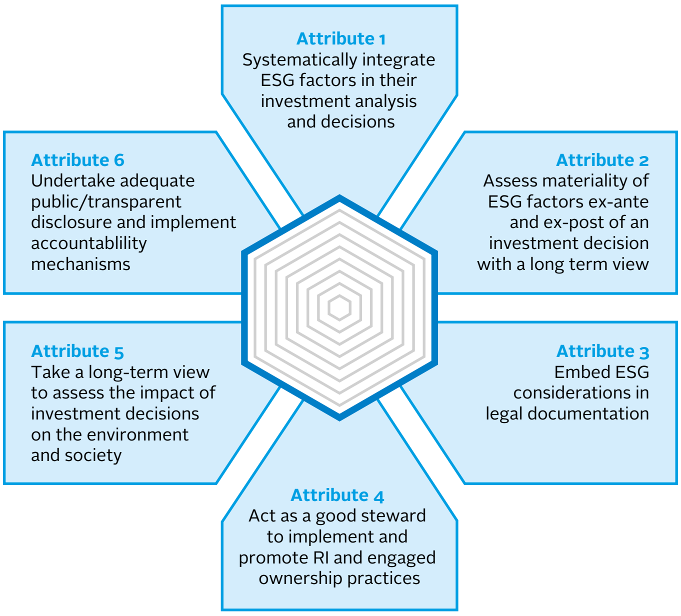
Figure 5: Investment manager journey to leading practice



5 See the PRI's Minimum requirements for membership article

The attributes set out in Figure 6 are based on analysis and review of the 2019 Reporting and Assessment data; asset owners should consider including these attributes in their manager assessment processes.

Figure 6: PRI investment manager core ESG attributes for leading practices. Based on responses by PRI signatories through the 2019 Reporting and Assessment Framework, for illustrative purposes only.



Investment manager longlisting should encompass traditional assessment criteria such as risk management, financial performance and costs alongside responsible investment practices, processes and outcomes. Responsible investment practices are becoming a decisive factor alongside traditional manager performance indicators at each step of the investment manager selection process. This ensures that ESG capabilities are not simply evaluated as an add-on activity (see Figure 16).

Asset owners can use investment managers' performance on process and corporate structures to condense the pool of applicants to a longlist. Based on data reported to the PRI by signatories, the first high-level ESG factors that asset owners typically assess are culture, governance, responsible investment policy, investment strategy and fund structure. Using those aspects, the asset owner might define certain minimum requirements around oversight, resourcing or policy implementation across the fund range. The Investment Manager Appointment Guide provides additional guidance in defining these requirements in the contractual agreements.

Culture

Culture is one of the most important aspects to consider when selecting an investment manager.[6] In this context, culture represents a set of habits, codes and expectations that govern how an organisation invests, regardless of its size and geographical location.

If there is no cultural fit between an asset owner and a potential manager, it is likely to prove challenging to establish a long-term investment relationship. This is particularly the case for the incorporation of ESG issues into investment processes or practices, and regarding how stewardship activities are undertaken on behalf of asset owners.

However, culture can be a nebulous concept. Questions about manager ownership and management alignment with the incentive structures, beliefs and values of decision makers are key components to assess. For example, it is important to find out whether a firm's culture is distribution-led, with incentives related to asset accumulation, or investment-led, with incentives reflecting investment outcomes. The quality of the manager's internal communication, especially between ESG specialists, investment teams and senior decision makers can provide evidence of the general understanding of ESG considerations across the organisation.

An investment manager culture that incorporates employees, supply chains and investee companies can be an indicator of a manager's ability to grasp its positive and negative impacts in the business ecosystem.[7]

Another important aspect of a manager's culture is its ability to share good practice with clients as well as industry collaboration through initiatives or policy advocacy efforts. Further, the investment manager's willingness to follow the asset owner on an educational journey can illustrate its ability to innovate and advance industry best practice.

6 PRI Reporting and Assessment Framework – Definition: Quality of management

7 Diversity, particularly gender, cultural background, age and race, are common aspects considered in manager selection.

Governance

A firm's approach to investment governance will depend on its culture, style and size. Sound governance ensures that a firm's responsible investment approach is embedded throughout the organisation. There are important distinctions between how a manager is governed at the firm and at the fund level.

Tables 1 and 2 set out some of the responsible investment aspects that an asset owner should consider, in addition to traditional governance analysis, in its governance due diligence when evaluating an investment manager at the firm and fund level.

Table 1: Firm governance. Source: PRI (2020) Technical guide: ESG incorporation in hedge funds

GOVERNANCE TOPIC	TRADITIONAL GOVERNANCE STRUCTURE AND ISSUES	RESPONSIBLE INVESTMENT STRUCTURE
Duty of care	▪ Fiduciary duty	▪ Fiduciary duty
Governing body and other supervisory bodies	▪ Board of directors ▪ Committees ▪ Separated business functions	▪ Responsible investment competence of governing bodies ▪ Separate responsible investment committee
Compliance	▪ Governing body ▪ Separate compliance function ▪ Risk management and reporting	▪ Reviewing the regulatory agenda, e.g. the EU Commission proposals on sustainable finance ▪ Monitoring and supervising the responsible investment commitment made to investors
Interests	▪ Alignment of interests ▪ Conflict of interests	▪ Responsible investment based KPIs and portfolio manager variable compensation
Resources and internal codes	▪ Internal manuals and codes ▪ Separated and clearly defined duties ▪ Education and training	▪ Responsible investment policy and training ▪ Proxy voting principles

Table 2: Fund governance. Source: PRI (2020) Technical guide: ESG incorporation in hedge funds

GOVERNANCE TOPIC	TRADITIONAL GOVERNANCE STRUCTURE AND ISSUES	RESPONSIBLE INVESTMENT STRUCTURE
Duty of care	▪ Fiduciary duty	▪ Fiduciary duty
Governing body and other supervisory bodies	▪ Board of directors	▪ Responsible investment board competence and training
Compliance	▪ Overall compliance oversight and monitoring ▪ Supervising managers' investment activity vs. investment guidelines	▪ Supervising responsible investment activity by manager vs. policy and regulatory requirements
Interests	▪ Board independence ▪ Fees paid by investors ▪ Conflict process	▪ Monitoring and supervising responsible investment process by manager to evaluate alignment and conflicts
Resources and internal codes	▪ Supervising and monitoring the state of processes, codes, potential changes and compliance	▪ Responsible investment policy and training

Responsible investment policy

When selecting an investment manager, asset owners should ensure not only that there is a formalised statement (policy) on the firm's responsible investment approach, but that they understand how the policy has been implemented and monitored, who oversees this process and where accountability sits.

As one of its minimum requirements for signatories, the PRI currently states that signatories must have a responsible investment policy[8] that formalises the firm's responsible investment approach and covers more than 50% of its assets under management.[9]

> **PRI RESPONSIBLE INVESTMENT POLICY DATABASE**
>
> The PRI has published a database of 1000+ publicly available investor responsible investment policies, serving as a powerful peer review tool.

Investment strategy and fund structure

When deciding on the appropriate investment strategy and fund structure, asset owners need to be aware of differing approaches taken by fund managers to addressing ESG factors and undertaking stewardship activities.[10] The asset owner has to make itself aware of the requirements laid out in the request for proposal before engaging in discussions regarding activities across those two dimensions.

Table 3 offers insights to where asset owners see a need for further industry development. This mirrors the evolution of ESG products moving from active investment to passive and from bespoke segregated accounts into fund-of-funds. It classifies the need to collaborate with the respective manager independent of the manager characteristics. This should be addressed through discussions with the investment manager across different investment strategies and fund structures. When evaluating a manager's stewardship activities, the asset owner should also consider insourcing those services or employing a third party if applicable. Asset owners also need to be wary of the potential for 'style drift' of a chosen investment strategy.

The investment strategies and fund structures outlined below have their various merits, but they need to be scrutinised by the asset owner when selecting a suitable investment manager.

Table 3: Engagement by asset owner with investment manager by type of investment strategy and fund structure. Source: PRI, for illustrative purposes only.

INVESTMENT STRATEGY	PRINCIPLE 1 - ESG INCORPORATION	PRINCIPLE 2 - STEWARDSHIP
Active (fundamental)	● ● ● ● ●	● ● ● ● ●
Passive	● ● ●	● ● ●
Quantitative (Systematic)	● ● ●	●
INVESTMENT STRATEGY	**PRINCIPLE 1 - ESG INCORPORATION**	**PRINCIPLE 2 - STEWARDSHIP**
Segregated mandate	● ● ● ● ●	● ● ● ● ●
Single-fund manager	● ● ● ● ●	● ● ● ● ●
Pooled fund	● ● ● ● ●	● ● ●
Fund-of-funds	● ● ●	●

Established industry practice:* ● ● ● ● ● Most established ● ● ● Moderately established ● Least established

* Identifies need for further collaboration between asset owners, investment managers and consultants.

8 The PRI guide An introduction to responsible investment: policy, structure and process provides an overview of good practice of responsible investment policy development.

9 See the PRI's Minimum requirements for membership

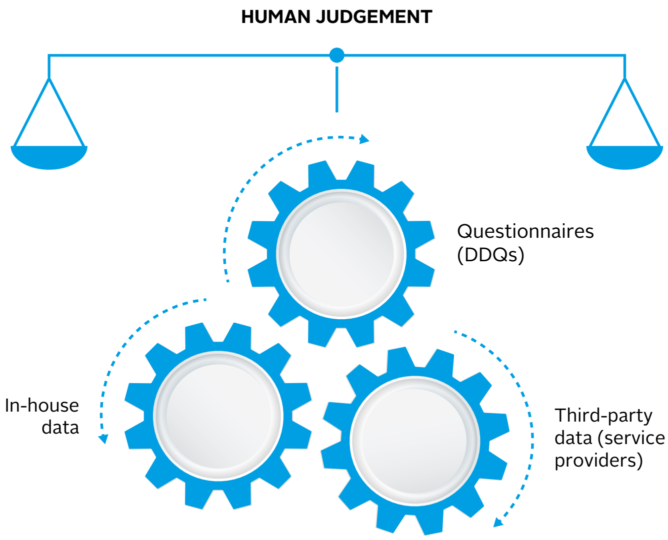
10 Forthcoming guidance on mandate requirements (Module 2 – AO programme) will address asset class-specific and fund structure ESG considerations.

INVESTMENT MANAGER SCORING

During the selection process, the asset owner is faced with a myriad of potential data sources with which to help assess managers, and which can provide insights in structured, unstructured, quantitative or open-ended forms. Scoring input factors could be derived from in-house databases, third-party data providers or questionnaires.

Human judgement needs to be applied to analyse the data collected and to incorporate and balance input factors. The asset owner will have to take a decision on the data input and its weighting. Its judgement – based on quantitative scores and qualitative judgements – will be instrumental to the final manager assessment.

Figure 7: Investment manager scoring input factors. Source: PRI



In-house data

Increasingly, asset owners are developing internal databases to inform the manager selection process. Insights gained from the manager monitoring phase are fed back into the process when building a longlist to fill a mandate. To learn more about how asset owners manage the monitoring process, see Investment Manager Selection Guide.

Third-party data

Thorough assurance and assessment should draw upon both internal and external information and data sources for decision making. This might require third-party data to be audited, using spot checks and independent assessments.

Data quality, breadth, integration frequency and transparency should be assessed in order to compare data providers. This assessment should inform the need for prioritisation or weighting adjustments between data sources. An asset owner might, for example, decide to weight input factors from corporate engagement practices higher than best-in-class ESG screening approaches or vice versa.

Asset class-specific due diligence questionnaires

An investment manager may not have the same level of ESG competency across all asset classes.[11] Managers' firm-level practices may also not be a good fit for all asset classes due to style, culture or resources. The extent to which ESG activities are embedded across the organisation may expose cultural and/or staff competency deficiencies in less-established asset classes.

When selecting an investment manager, asset owners should first look at the firm's overall ESG alignment, then its capability in a specific asset class, before choosing a suitable fund or investment. ESG competency related to specific asset classes within a mandate should be evaluated.

Across the PRI signatory base, asset owners use asset class-specific due diligence questionnaires (DDQs) to collect insights on investment managers. DDQs are a fundamental source of information and they can be used throughout the long- and shortlisting process.

INVESTMENT MANAGER DUE DILIGENCE QUESTIONNAIRES

The PRI has provided or is developing sample responsible investment questionnaires for the following asset classes:

■ Equities*	■ Real estate
■ Fixed income*	■ Private debt
■ Private equity	■ Forestry
■ Hedge funds	■ Farmland
■ Infrastructure	

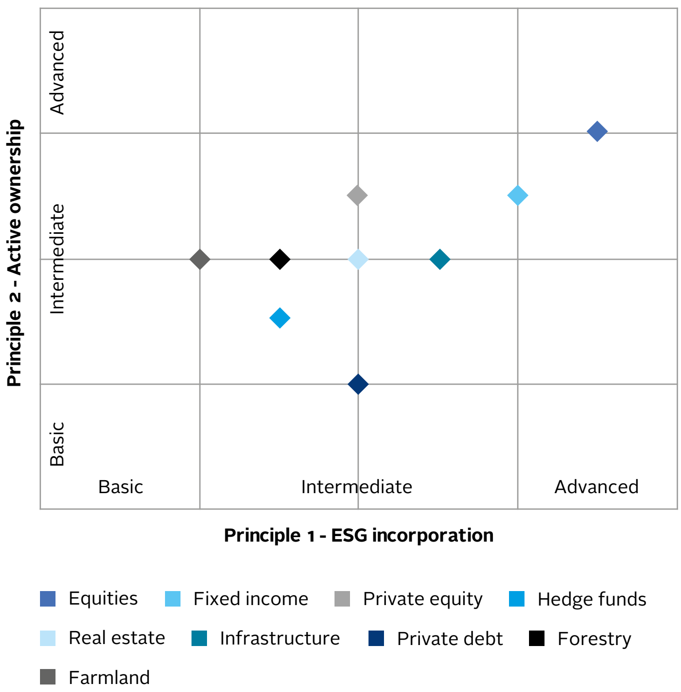
Questionnaires have been developed in collaboration with leading asset owner and investment manager signatories to provide the industry with a standardised set of diligence questions to ask prospective investment managers. The failure of a manager to provide sufficient responses to questionnaires can lead to an early elimination from the longlisting process, effectively making answering these questionnaires a minimum requirement to be eligible for investment.

*in development

11 Further resources for asset class-specific investment manager selection include the following PRI publications:
- Technical guide for limited partners: Responsible investment in private equity
- ESG monitoring, reporting and dialogue in private equity
- Listed Equity: Assessing external managers and service providers

Responses to DDQs are summarised, evaluated and, in many cases, weighted or scored at the asset owner's discretion. This process offers a high-level assessment of the investment manager's ESG attributes and plays an integral role in creating a shortlist of managers. To transform questionnaire responses into scorable information, the asset owner might develop scoring methodologies and make use of scorecards (see Manager assessment responsible investment scores). This could apply to the predefined manager universe. The asset owner's or consultant's available resourcing will determine the depth of assessment at the longlisting level. In practice, an asset owner might focus on the PRI's Principles 1 and 2 – incorporating ESG into investment analysis and decision-making, and into ownership practices – at the asset-class level (see Figure 8), weighted against its own responsible investment framework.

Figure 8: Examples of a manager's responsible investment capabilities by asset class. Source: PRI, for illustrative purposes only



Manager assessment responsible investment scores

Scoring of managers' responsible investment capabilities can be performed at the firm or fund level. Scoring can also be issue-specific rather than covering an overall approach. The three ESG dimensions can be evaluated against the asset owner responsible investment framework and the expectations for each specific mandate.

The PRI's Reporting and Assessment Framework is often used by asset owners for manager selection purposes.[12] The scores that signatories are given as part of the annual PRI signatory assessment process can provide a basis for analysis.

THE PRI FRAMEWORK IN PRACTICE

The PRI Data Portal provides access to information on signatory responses concerning ESG processes and performance. Asset owners can use the portal to:

- Search for organisations and access or request available reports. And organisations to lists you created
- View the transparency and assessment reports of your organisation
- Create and manage your lists. Request access and view reports through your lists
- Export signatories' public responses to the PRI reporting framework

In addition to publicly available Reporting and Assessment reports, asset owners may request access to private Transparency and Assessment reports. Data Portal requests to share these reports are approved in 60% of cases.

Signatories can also extract detailed reported information in an aggregated form on specific areas of interest. An asset owner could, for example, download all publicly disclosed investment manager responses to the PRI's listed equity ESG integration module, or create lists of managers for advanced data analysis.

Regularly updated analysis of how signatories are utilising the tool can be found here.

12 During an asset owner workshop at the 2019 PRI in Person conference, 42% of asset owner participants said they used the PRI's Reporting and Assessment framework in their manager selection process.

Based on data from the 2019 PRI Reporting and Assessment Framework, the guide provides an example of aggregate scoring in Table 4 below. It illustrates how a group of investment managers might be scored, based on qualitative and quantitative assessments of their responsible investment capabilities.

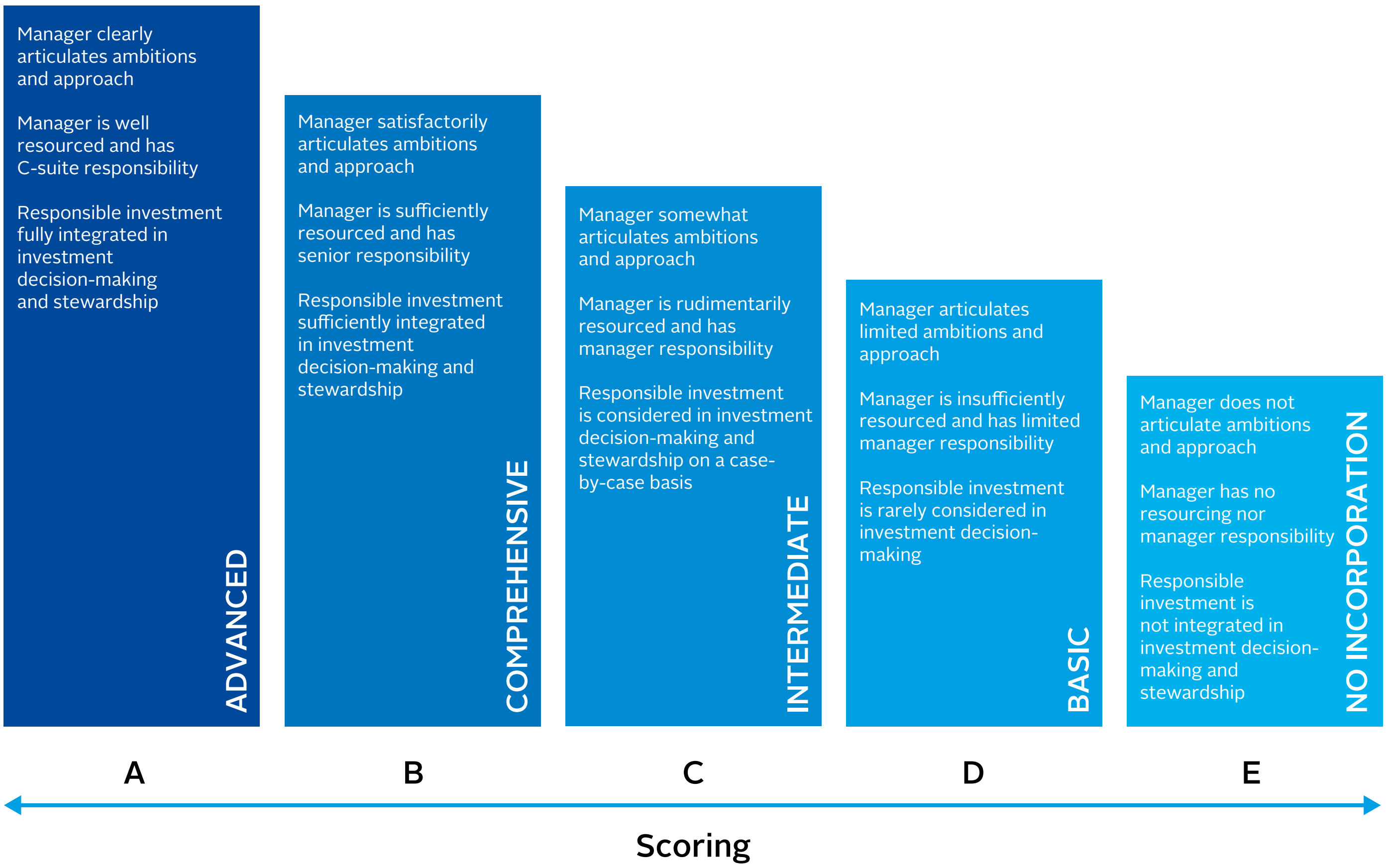
Table 4: Investment manager sample score card. Source: PRI. Based on data from the 2019 PRI Reporting and Assessment Selection, Appointment and Monitoring module, darker colours indicate advanced practice, for illustrative purposes only.

	INVESTMENT MANAGER SCORECARD														
Investment manager	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**
Attribute 1															
ESG integration in investment analysis															
ESG integration in investment decision making															
Attribute 2															
Assess ESG ex-ante															
Assess ESG ex-post															
Attribute 3															
Integration in legal documentation															
Attribute 4															
Stewardship															
Attribute 5															
Long-term view on outcomes in environment															
Long-term view on outcomes in society															
Attribute 6															
Public disclosure															
Accountability mechanisms															
Total score (weighted %)	100	100	95	87	85	75	68	55	46	30	27	27	19	12	8
Momentum	↑	←→	↑	↓	←→	←→	↓	↑	↓	↓	←→	↓	←→	←→	←→
Category	**Leading**				**Midfield**							**Beginners**			

With ongoing monitoring activities generating growing volumes of increasingly granular data, asset owners are creating datasets that can facilitate effective decision-making. Investment consultants and dedicated service providers have stepped in to fill data gaps. Third-party proprietary tools are often combined with internal knowledge and opinions when preparing selection reports for investment committees.

Scoring systems might utilise points, weighting or traffic light systems. Scoring mechanisms can be used to determine cut-off points below which managers are ineligible for selection, or as a tool for engagement (see Figure 9). Asset owners might also use those categorisations to define outstanding or best-in-class performance.

Figure 9: Investment manager ESG scoring methodology example. Source: PRI. Based on data from the 2019 PRI Reporting and Assessment Selection, Appointment and Monitoring module, for illustrative purposes only.



Asset owners may decide against disqualifying managers on the grounds of poor ESG performance but rather use their client-manager relationship to help the manager address areas of weak ESG performance. For example, measurable targets for mandatory training or knowledge exchange can be incorporated in the appointment phase and legal documentation.

Importantly, managers should report on their development on a regular basis. See the Investment Manager Monitoring Guide for an in-depth discussion of reporting requirements.

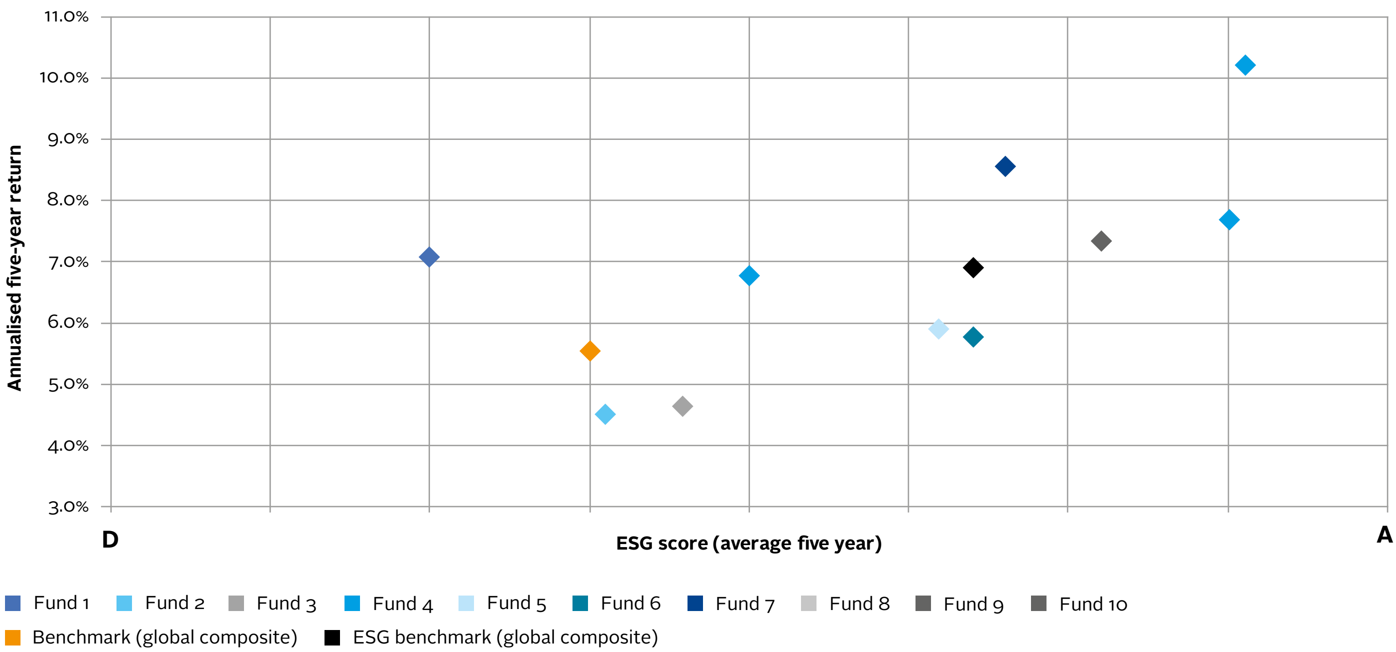
INVESTMENT MANAGER ESG PEER REVIEW AND BENCHMARKING

Investment manager peer review

The peer review of investment managers can encompass statistical analysis of performance data, ratios (i.e. Sortino, Sharpe or Treynor), and ESG scores or assessments. Each manager can be evaluated and compared against a benchmark or other investment managers with similar characteristics.

This process aims to identify leading performers with ESG attributes. Figure 10 gives an example of an integrated approach where ESG scores are combined with investment performance data to provide an integrated responsible investment manager assessment.

Figure 10: Integrated ESG peer review example. Source: PRI. For illustrative purposes only.



Investment manager benchmarking

Asset owners use performance benchmarks to compare investment managers against their peers. ESG performance benchmarks can help categorise a pool of managers into leaders and laggards by asset class or other qualifying characteristics (e.g. metrics such as carbon footprinting, governance standards or fund labelling). They can also provide the asset owner with insights into the average composition of its target group and can highlight low-scoring areas.

Regulators around the world are starting to develop guidelines that require investment managers to report and disclose against ESG metrics. This trend is creating a comparable market for benchmarking and peer-review purposes. The EU Sustainable Finance Benchmarking Regulation offers a practical example for investment manager benchmarking against fund characteristics regarding environmental targets in portfolios.

EU SUSTAINABLE FINANCE BENCHMARK REGULATION – A TOOL FOR MANAGER BENCHMARKING

In order to improve comparability among investment managers, the EU proposes two climate- aligned benchmarks – the Paris-Aligned Benchmark (PAB) and the Climate Transition Benchmark (CTB) – that which can be utilised to compare managers on aspects of their environmental performance at the fund level.

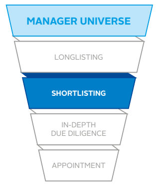
Differentiation. The two types of climate benchmarks are pursuing a similar objective but differentiate themselves in terms of their level of restrictiveness and ambition. EU PABs are designed for highly ambitious climate-related investment strategies and are characterised by stricter minimum requirements, while the EU CTBs allow for greater diversification and serve the needs of institutional investors in their core asset allocation.

MINIMUM STANDARDS	EU CTB	EU PAB
Risk oriented minimum standards:		
Minimum Scope 1+2(+3) carbon intensity reduction compared to investable universe	30%	50%
Scope 3 phase-in	Up to 4 years	Up to 4 years
Baseline Exclusions	Yes Controversial weapons Societal norms violators	Yes Controversial weapons Societal norms violators
Acivity Exclusions	No	Coal (1%+ revenues) Oil (10%+ revenues) Natural gas (50%+ revenues) Electricity producers with carbon intensity of lifecycle GHG emissions higher than 100g$CO2_e$/kWH (50%+ revenues)
Opportunity oriented minimum standards:		
Year-on-year self-decarbonisation of the benchmark	At least 7% on average per annum: in line with or beyond the decarbonisation trajectory from the IPCC's 1.5°C scenario (with no or limited overshoot)	
Minimum green share/brown share ratio compared to investment universe (VOLUNTARY)	At least equivalent	Significant larger (factor 4)
Exposure constraints	Minimum exposure to sectors highly exposed to climate change issues is at least equal to equity market benchmark value	
MINIMUM STANDARDS	**EU CTB**	**EU PAB**
Corporate Target Setting	Weight increase shall be considered for companies which set evidence-based targets under strict conditions to avoid greenwashing (see Article 9 in section 5.12 re conditions)	
Disqualification from label if 2 consecutive years of misalignments with trajectory	Immediate	Immediate
Relevance oriented minimum standards:		
Review Frequency:	Minimum requirements shall be reviewed every three years to regnise market development as well as technological and methodological progress.	

Source: EU Technical Expert Group on Sustainable Finance (2019) Report on benchmarks

INVESTMENT MANAGER FEEDBACK

It is important to proactively offer formal feedback to managers who did not make the shortlist to help improve their responsible investment activities. This feedback is a valuable tool that provides managers who are starting their responsible investment journey with the opportunity to learn and adapt. Feedback can be delivered through data sharing or face-to-face discussions. This process will depend on the asset owner's resourcing and ability to provide this service.



SHORTLISTING OF INVESTMENT MANAGERS

This section covers the assessment of investment managers' portfolio construction and risk management, and addresses verification of the responsible investment process. It also details ESG incorporation in the investment process, activities linked to stewardship activities and outcomes from investments.

After engaging in an initial longlisting process, the asset owner will test the manager's abilities in more detail to arrive at a manageable number of shortlisted candidates. This step also ensures that the investment manager is able to deliver on the specifications of the mandate and has the asset class and/or regional expertise in place and appropriate ESG integration skills.

ASSESSMENT OF INVESTMENT MANAGER PORTFOLIO CONSTRUCTION AND RISK MANAGEMENT

In many cases, the asset owner has to consider portfolio determinants such as asset-liability matching management, the longevity of the beneficiary base, funding status and applied discount rates and associated shortfall risk. ESG factors may enter a manager's portfolio construction process via different responsible investment approaches such as ESG integration, screening and thematic investing. An asset owner will test the manager's ability to apply those approaches according to the requirements laid out in its investment strategy and responsible investment policy.

Incorporating ESG factors in portfolio construction can introduce portfolio skews with implications for the investable universe, diversification characteristics and investment capacity. Assessing an investment manager's ability to balance these skews with portfolio returns and risk management is an important step in the assessment process.

The asset owner will also need to review how ESG factors are integrated into the investment manager's risk management processes. The following figures provide examples of risk assessment frameworks that can test if the investment manager has understood and assessed ESG risks. Table 5 provides a framework for ranking and assessing ESG factors in credit analysis. Heat maps can be a useful synthetic indicator to help prioritise material ESG factors and provide a relative assessment of their potential impact (whether risk or opportunity).

Table 5: Example of a credit risk framework. Source: PRI (2019) ESG, Credit risk and ratings: Part 3 – from disconnects to action areas, for illustrative purposes only.

LIKELIHOOD					
Almost certain	Moderate	Major	Critical	Critical	Critical
Likely	Moderate	Major	Major	Critical	Critical
Possible	Moderate	Moderate	Major	Major	Critical
Unlikely	Minor	Moderate	Moderate	Major	Critical
Rare	Minor	Minor	Moderate	Moderate	Major
	Insignificant	Minor	Moderate	Major	Critical

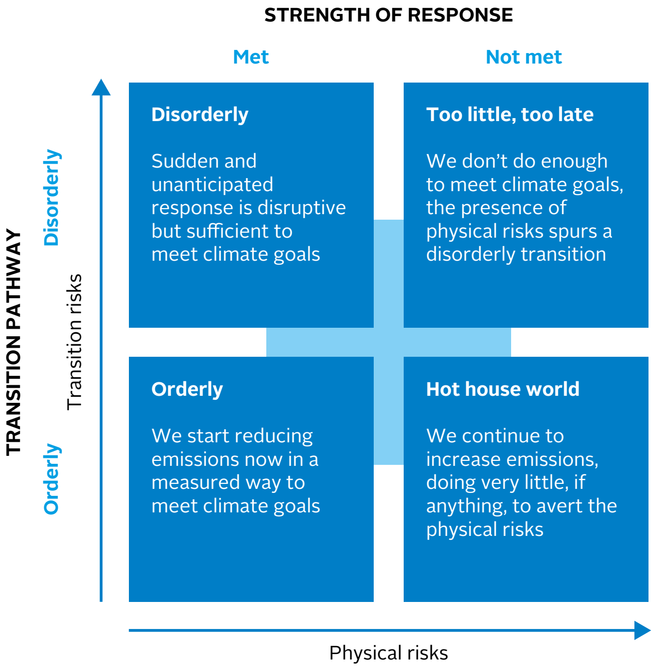
FINANCIAL IMPACT

ESG risk frameworks regularly consulted by PRI asset owner signatories include:

- The Sustainability Accounting Standards Board;
- The Global Reporting Initiative;
- The International Finance Corporation Performance Standards; and
- The Recommendations of the Task Force on Climate-related Financial Disclosures.

Figure 11 depicts a framework for assessing climate-related risks to evaluate their impact on the economy and financial stability. This incorporates the different possible outcomes for climate change and the policies to mitigate it, an assessment of their financial impact and a determination of the timeframes during which risks could materialise.

Figure 11: Example of a climate change risk framework. Source: Bank of England (2019), [The 2021 biennial exploratory scenario on the financial risks from climate change]



Material ESG risks need to be incorporated into the investment process and risk assessment alongside traditional risk/return metrics. The manager's operational capabilities to respond to those risks should involve scenario analysis, stress testing and robust risk measures.

RESPONSIBLE INVESTMENT PROCESS, STEWARDSHIP AND OUTCOMES VALIDATION

An important step in the selection process is to validate the information provided by the investment manager. Testing the investment team's ESG incorporation skills, its activities around ownership duties, and the ability to recognise positive or negative outcomes from its investment decisions should be part of the asset owner's assessment framework.

The responsible investment process

Verification of an investment process can be undertaken in a number of ways. The PRI's Principle 1 outlines a key aspect of responsible investment in the incorporation of ESG factors into an investment process.

An asset owner might not be prescriptive about the exact process of ESG incorporation, but it should require the manager to provide detail about the methodologies and data used to arrive at investment decisions using examples such as valuation methodologies or risk frameworks. The PRI's work on specific asset classes provides additional insights to inform those discussions.[13] The example given in Figure 12 can provide a basis for those.

13 PRI Investor Tools

Figure 12: ESG incorporation in listed equity across the active-to-passive spectrum. Source: PRI (2020) An introduction to responsible investment: Listed equity.

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.

The PRI's second principle – that signatories practice active ownership – applies to both asset owners and investment managers. Asset owners therefore need to assess the investment manager on its ability to: engage with investee companies; measure and report the impact of engagement; and ensure alignment with the asset owner's preferences and policy. This might also include assessing the investment manager's motivation for engaging with investee assets.

Read more about the PRI's position on active ownership in the paper Active Ownership 2.0: the evolution stewardship urgently needs.

Asset owners can engage with the issuers of securities on three levels:

DIRECT ENGAGEMENT

- Discussing ESG issues directly with issuers in order to improve their handling, including disclosure, of such issues.

COLLABORATIVE ENGAGEMENT

- May include asset owners and investment managers and is unlikely to be the sole method of engagement.

OUTSOURCED ENGAGEMENT

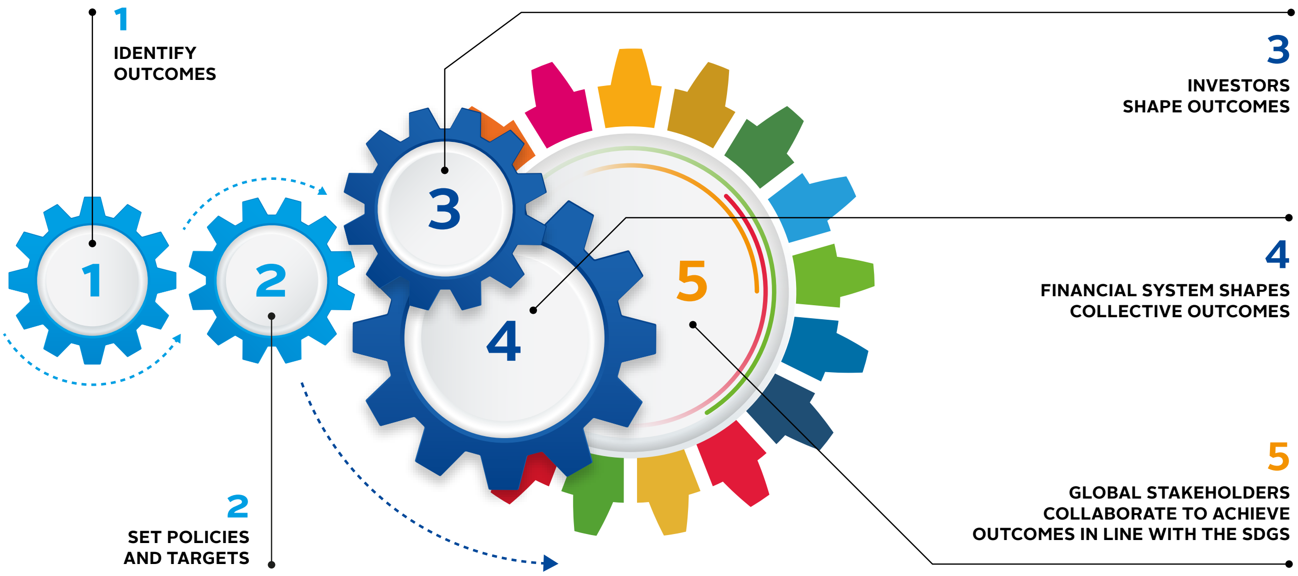
- Carried out by an investment manager (who may sub-contract to service providers); or
- Carried out by specialist service provider (directly contracted by an asset owner).

Outcomes from investments

Investment decisions and active ownership shape outcomes in the real world. For example, they may increase or decrease pollution levels, support employment, lead to discrimination or support inclusion.

Considering positive and negative outcomes of investment decisions can be a first step for an asset owner to acknowledge and subsequently address the outcomes of its investments. The PRI has developed a five-part framework to help investors incorporate SDG outcomes into investment decisions and engagement.

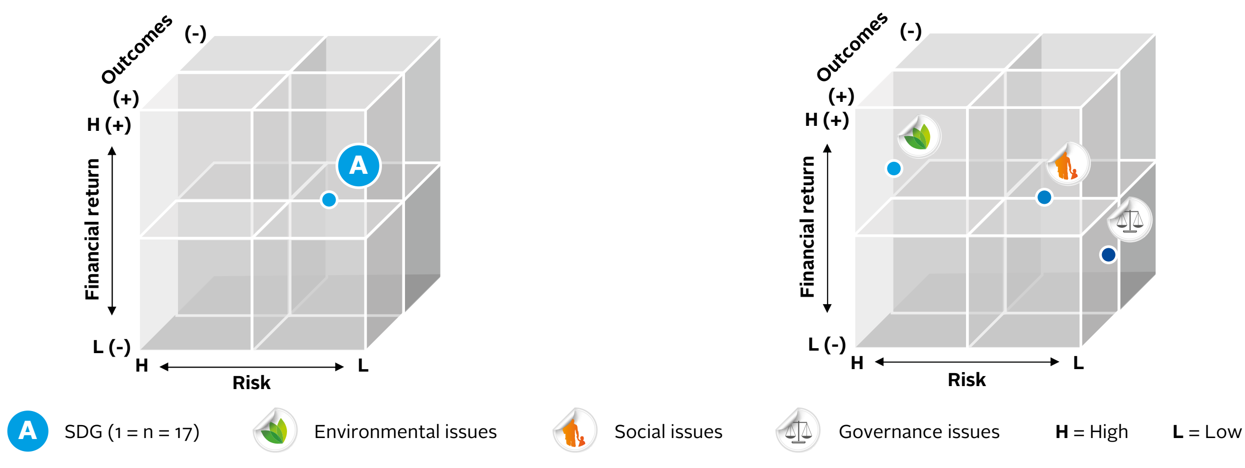
Figure 13: Five-part SDG outcomes framework for investors. Source: PRI (2020) [Investing with SDG outcomes: A five-part framework](#).

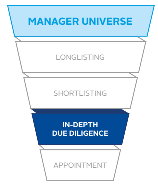


Discussions with the manager on outcomes can be included when evaluating the portfolio construction and investment decision-making processes. Focusing on SDG-aligned outcomes, including through collective action, can also feed back into portfolio performance and into the resilience of the financial system itself.

As an example of this process, Figure 14 proposes a three-dimensional framework for the integration of outcomes into the traditional risk/return framework for strategic asset allocation.

Figure 14: Investment manager responsible investment capabilities per outcome objectives. Source: adapted from PRI (2020), Embedding ESG issues into strategic asset allocation frameworks, for illustrative purposes only.





IN-DEPTH DUE DILIGENCE

This section covers the documentation and performance track record of an investment manager. It also discusses the importance of onsite visits and interviews with the investment team and other operational teams. It concludes with the decision to select an investment manager.

When performing in-depth due diligence, the asset owner will test its ability to choose the right investment manager and can re-evaluate any previous assessment it has made.

DOCUMENTATION AND RESPONSIBLE INVESTMENT TRACK RECORD

The in-depth due diligence process will include the submission of supplemental information on the manager's performance track record and other financial and non-financial performance indicators. These can be complemented by detailed information on the fund structure, applied benchmarks, allowance for tracking error and ESG methodologies such as negative screens (e.g. ex-tobacco), tilts (e.g. low carbon) or more sophisticated ESG integration techniques.

INDICATIVE LIST OF DOCUMENTS

- [ ] Responsible investment policy
- [ ] Responsible investment reports
- [ ] Responsible investment methodology
- [ ] Data sets and portfolio analysis
- [ ] Impact reports
- [ ] Incidence reports
- [ ] Marketing materials
- [ ] Prospectus (offering memorandum)
- [ ] Performance summary
- [ ] Operational contingency and corrective plan
- [ ] Operative manual
- [ ] Service provider list
- [ ] Compliance manual
- [ ] Code of conduct
- [ ] Financial statements

ONSITE VISITS AND DETAILED DUE DILIGENCE

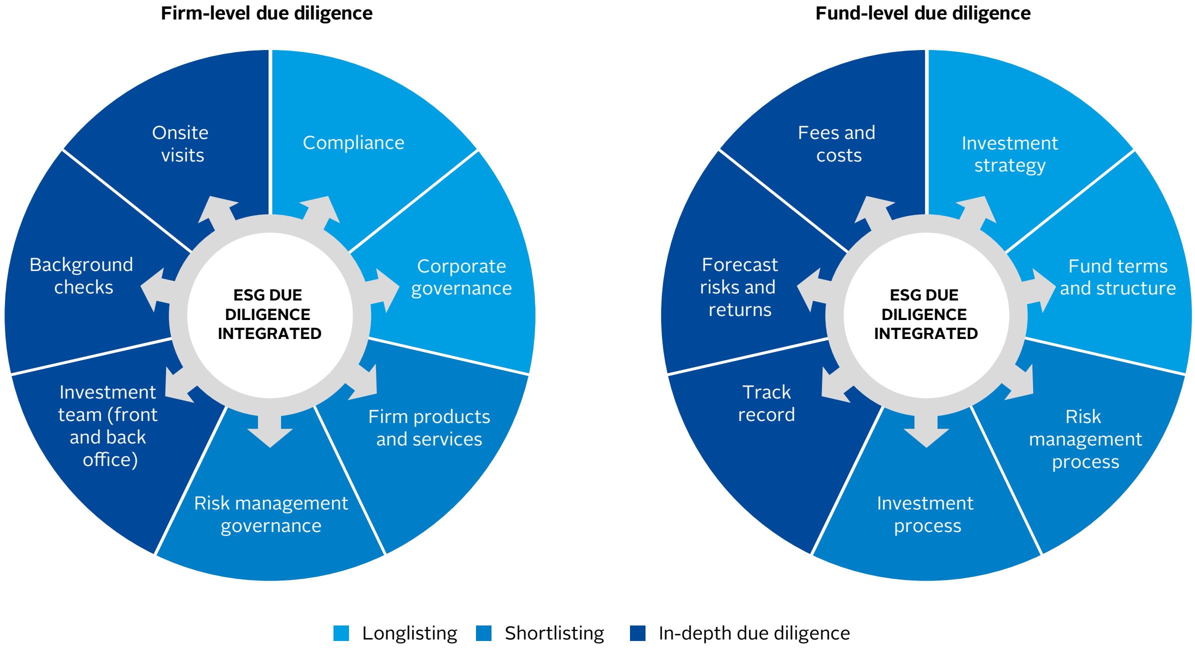
Once the asset owner has narrowed down the pool of applicable investment managers, onsite visits, interviews and in-person meetings with the investment and operational and/or responsible investment teams can provide additional insight into manager resources to ensure meaningful ESG incorporation in the investment process. This in-depth due diligence process will involve mainstream practices, but the manager selection process should also address ESG factors throughout.

For example, in-person meetings with the investment team can be used to verify claims made by the manager in the initial screening phase. Taking a deep dive into the investment process as part of due diligence can reveal if the manager is able to deliver on the investment objectives formulated in response to the RFP. These discussions and interviews might enable the asset owner to identify periods of underperformance due to ESG risks and evaluate the manager's skill during those periods. Asset owners can compare performance data against ESG scores to enhance the selection process. These periods might be identified using performance dashboards, such as that shown in Figure 15.

Figure 15: Example of a performance dashboard – fund review. Source: PRI. For illustrative purposes only.

Figure 16 presents a list of indicative areas to cover in the in-depth operational and investment due diligence process, ensuring thorough coverage of all aspects of ESG activities.

Figure 16: Example of ESG-integrated firm and fund due diligence. Source: PRI, for illustrative purposes only.



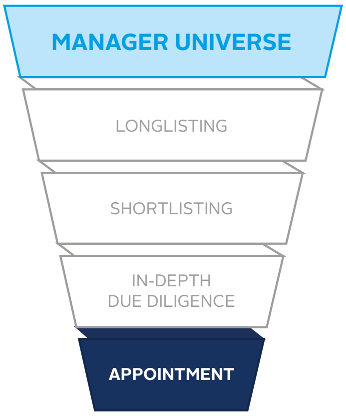
CONCLUDING INVESTMENT MANAGEMENT SELECTION

In the investment manager selection process, the importance of human judgement is sometimes overlooked. At this stage, the asset owner should have gathered enough information to make an assessment of the manager's ability to make decisions that best serve the asset owner's long-term goals.

In order to feed into a comprehensive decision-making process, an asset owner should identify a manager who:

- is aligned with its investment principles and beliefs;
- systematically integrates ESG factors into investment decisions;
- analyses ESG materiality before and after investments;
- acts as a good steward and implements responsible investment and engagement practices;
- addresses positive and negative outcomes caused by its investments; and
- undertakes adequate public/transparent disclosure and implements accountability mechanisms.

MANAGER APPOINTMENT



Following the selection process, the asset owner establishes a contractual relationship with the investment manager.

To continue reading about this process, see the Asset owner technical guide: Manager appointment.

CREDITS

AUTHORS:

Felix Soellner, PRI
Marisol Hernandez, Formerly PRI
Gail Boucher, PRI
Toby Belsom, PRI

EDITOR:

Mark Nicholls, Independent Editor

DESIGN:

Will Stewart, PRI

The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org