PRI Principles for Responsible Investment

ALIGNING EXPECTATIONS

GUIDANCE FOR ASSET OWNERS ON INCORPORATING ESG FACTORS INTO MANAGER SELECTION, APPOINTMENT AND MONITORING

FEBRUARY 2013

UNEP Finance Initiative
Innovative financing for sustainability
United Nations Global Compact

THE PRINCIPLES FOR RESPONSIBLE INVESTMENT

The Principles for Responsible Investment were launched by the UN Secretary-General at the New York Stock Exchange in April 2006. The Preamble to the Principles states:

‘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 corporate 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.’

The PRI’s Mission Statement – agreed by the Advisory Council in March 2012 is:

We believe that a sustainable global financial system that is efficient in economic terms is a necessity for long-term value creation, rewards long-term responsible investment and benefits 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 for their implementation; fostering good governance, integrity and accountability; and addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

THE SIX PRINCIPLES THEMSELVES ARE:

1 **We will incorporate ESG issues into investment analysis and decision-making processes.**

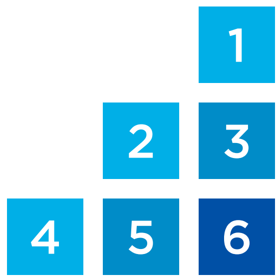
2 **We will be active owners and incorporate ESG issues into our ownership policies and practices.**

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.**



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ABBREVIATIONS

AO	**Asset owner.** *In this document, an AO refers to an organisation whose assets are being managed by an external manager*
ESG	Environmental, social and governance
IM	Investment manager
IMA	Investment management agreement
RFP	Request for proposal
RI	Responsible investment
SP	Service provider

DEFINITIONS

ENGAGEMENTS	Engagements are all interactions between an investor and investees or policy makers to address ESG issues or business strategy. The objective of engagement can be to monitor performance or to exercise influence over a company's practice and performance on ESG issues.
POOLED FUNDS	Investment vehicles in which assets from individual investors are aggregated for the purposes of investment. In general, the investors in these funds tend to have less influence over the investment criteria for these funds than for segregated mandates.
SEGREGATED MANDATE(S)	Investment(s) run exclusively on an investor's behalf where investment criteria (which may include how ESG issues are considered in the investment process or expectations around engagement or voting) are determined in consultation with the investor and assets are managed in accordance with these criteria.

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FOREWORD

By Rob Lake,
Director of Responsible Investment, PRI

Today, a growing number of asset owners (AO) acknowledge the need to understand how an array of environmental, social and governance (ESG) issues might materially affect the performance of their portfolios over the longer term. Sitting at the top of the investment chain, they are exerting their influence to request their managers to embed the analysis of ESG factors into their investment activities. By doing so, they are ensuring that they discharge fully their fiduciary duty to clients and beneficiaries.

AOs' beliefs and expectations on how ESG issues should be managed to best contribute to portfolio returns, across asset classes and over time, may not always be fully in line with those of their investment managers. Ensuring that the interests between the two parties are aligned is a fundamental requirement for the delivery of sustainable portfolio returns over the longer term. It is also central to the mission of the Principles for Responsible Investment (PRI) Initiative, which is to support our signatories to contribute to the development of a more sustainable global financial system.

AOs that believe ESG issues will impact the financial performance of their portfolios will be concerned with how their managers identify and manage these factors, whether their voting and engagement are in line with their expectations, and whether they disclose these activities in a timely, robust, and meaningful way. However, the PRI Initiative's 2011 Report on Progress suggests there is still progress to be made in the extent to which asset owners include ESG criteria in their manager search and monitoring, and in investment management agreements (IMA) and incentive structures. Only around one third of AO signatories currently include specific clauses about ESG integration in their manager agreements, while one third make no reference at all.

This new guide provides a framework for AOs who appoint and monitor external managers to assess whether their managers' investment policies and processes are consistent with their ESG expectations. It aims to support them in their dialogues with managers so that they gain a clear understanding of the ESG risks and opportunities affecting their portfolios and how their managers are addressing them. This guidance is also relevant for fund-of-fund managers who outsource investment activities and who need greater confidence that managers are aligned with their own expectations.

Aligning the interests of AOs and their managers is not a new challenge. Industry bodies and leading AOs alike have pursued initiatives to address the issue. Through its collaborative network, the PRI has drawn together case studies that will enable AOs to adopt an approach that suits their investment strategy and style. Examples from London Pensions Fund Authority (UK), Catholic Superannuation Fund (Australia) and CalSTRS (US) highlight the increasing awareness and capabilities that AOs have in setting and communicating their ESG-related expectations to their managers. PGGM (Netherlands), RobecoSAM (Netherlands) and Co-op Asset Management (UK) show how investment managers are rising to the challenge of integrating ESG factors into their investment decision-making. We also point readers to resources from ICGN and ACSI, demonstrating the synergies that can be generated from the collaborative efforts of industry initiatives.

The PRI initiative encourages its signatories and the broader AO community to reflect these ideas in their manager selection, appointment and monitoring. This will help to ensure that what clients expect on ESG and what managers deliver are aligned. Investors may find it useful to refer to the new PRI Reporting Framework for further ideas on how to translate their ESG expectations into questions they can ask their managers about specific asset classes.

The PRI Secretariat hopes this guide will assist AOs by demonstrating how their global peers are working with their managers to embed ESG risks and opportunities into the investment chain. We would welcome comments on the document, and will continue our work in this important area.

I: DEVELOPING ESG-RELATED EXPECTATIONS

ESG factors are an important dimension of investment expectations and should be considered a part of an AO's overall expectations for their fund's financial performance. A clear set of expectations or objectives provides logic and coherence to the investment process over time. Expectations also assist investors in setting the context and formulating a framework of questions to ask when selecting, appointing and monitoring IMs.

AOs/IMs may have differing investment beliefs and expectations. For example, an AO/IM who believes that ESG factors will materially impact the financial performance of their funds will likely be concerned with how ESG factors are analysed, managed and disclosed and how these factors impact investment decisions. Likewise, an AO whose investment strategies are influenced by certain values or themes will likely be concerned with their managers' capability to accommodate these requirements.

Regardless of differing beliefs and approaches, an AO should ensure that a coherent set of expectations is communicated to agents acting on their behalf. They can also seek to align incentive structures with these expectations.

Figure 1 demonstrates how the development, application and review of ESG-related expectations is a continuous process.

To ensure that ESG-related expectations are systematically applied, they should be translated into decision-making criteria and communicated to IMs. Expectations and decision-making criteria should be clearly understood by those responsible for these activities.

Figure 1: Developing, applying and reviewing ESG-related expectations

Source: PRI Research

ESG-related expectations and decision-making criteria will evolve as an AO's perspective of market factors and sustainability issues changes and as the RI industry matures. Any substantial changes to an AO's expectations for investment activities should be communicated to their IMs and agreed upon.

EXAMPLE OF WORKING WITH INVESTMENT CONSULTANTS

If an AO is working with an investment consultant, it is important to ensure that the consultant fully understands and implements the AO's ESG-related expectations.

During the consultant selection process, **StatewideSuper (AO, Australia)** included the following ESG question in their request for proposal (RFP):

Describe your firm's policy with respect to 'ESG' matters. Please also provide an overview of how ESG considerations are integrated into your process.

Subsequently, StatewideSuper worked with the newly appointed consultants to develop ESG-related questions to be included in the RFP for the selection of managers. Also in conjunction with the consultants, StatewideSuper developed suitable ESG-related clauses for their investment management agreements (IMAs).

During initial discussions on the manager evaluation process, the consultant was reluctant to assess and grade potential managers based on their ESG approaches. This was partly because StatewideSuper did not have a manager grading framework that applied ESG-related criteria which it could supply to the consultant, and also because the consultants felt that a manager's approach to ESG was an aspect of their style rather than something that should be evaluated in itself. To address this issue, a basic scoring system for managers was developed and shared with the consultants. The consultants then agreed to adopt this framework for StatewideSuper's manager search and evaluation processes.

Subsequently the consultants have expanded their inclusion of ESG, in response to client requests, and developed a manager ESG survey for the purpose of understanding the level of ESG integration by managers and the main drivers for doing so.

Identifying and understanding ESG-related expectations is admittedly a challenging process that requires investors to reflect upon their entire organisation, from stakeholders to strategy and from governance to processes and products.

This section will propose RI topics for which an AO may wish to develop expectations. It will propose a collection of non-exhaustive guidance points that investors may follow in formulating expectations. This section also provides examples of good practice and resources from PRI signatories and industry organisations, enabling investors to learn from their peers.

EXAMPLE OF ESG-RELATED EXPECTATIONS, MANAGER SELECTION QUESTIONS AND DECISION-MAKING CRITERIA

Environment Agency Pension Fund (EAPF) (AO, UK) has integrated ESG factors into its investment processes since 2001. Over the years, some of the lessons they have learned include: the need to focus on the manager's ESG conviction, reducing the number of questions in their ESG questionnaire, and developing decision-making criteria to determine if ESG factors are integrated into the manager's decision-making processes.

The following are some expectations that EAPF has of their IMs:

- The IM ensures that financially material ESG risks and opportunities are built into investment research, idea generation, selection of investments, and portfolio management.
- The IM undertakes company engagement to protect shareholder rights, highlights financially material ESG issues, votes actively and refers environmental resolutions to EAPF to get its advice on voting.
- The IM undertakes joint research and advocacy and participates in EAPF's environmental foot-printing initiatives.
- The IM undertakes positive selection of financially robust investments that contribute towards sustainable development.

During the RFP process, EAPF asks the IM to clarify:

- What are the IM's RI resources?
- How are ESG risks and opportunities factored in? (Including details of internal or external ESG assessment methodologies that are used in the investment process.)
- Evidence of commitment to relevant RI codes/principles/initiatives such as UK Stewardship Code and the PRI.

Examples of their ESG-related decision-making criteria include:

- If the IM conducts ESG analysis internally, it is conducted on the basis of information provided by external parties.
- The IM pays attention to both financial and ESG criteria during fundamental stock analysis.
- The IM integrates ESG criteria into its scoring analysis of stocks.

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EXAMPLE OF DEVELOPING, APPLYING AND REVIEWING ESG-RELATED EXPECTATIONS

The **London Pensions Fund Authority (LPFA) (AO, UK)** recently developed a set of expectations of their segregated equity IMs regarding RI activities, with a view to expanding to other asset classes in the near future. To inform these expectations, they visited a number of IMs known to undertake leading practices on RI, with a particular interest in gaining insight into where best practice lies within the following areas:

- IM incentive structures which incorporate longer performance periods with clawback mechanisms and consideration of ESG issues.
- Systematic integration of ESG risks/opportunities into the investment decision-making process from high level screening and industry analysis to company valuation, portfolio construction and on-going monitoring.
- Evidence of a connection between active ownership activities and portfolio-specific ESG risks/opportunities.
- Transparency on ESG reporting to clients.

This exercise allowed LPFA to develop two things:

- A set of achievable expectations.
- A benchmark by which to judge their IMs' ESG performance.

Some key conclusions from this process were:

- **Moving from policy to evidence of implementation:** LPFA would like to have more challenging and granular discussions with their IMs around how ESG data is integrated into the investment process. Obtaining ESG risk data on its investee companies is one way this could be achieved.
- **Pressing for greater evidence of the impact of an IM's RI activities on LPFA's portfolio.** Where it exists, current RI reporting is insufficient to determine how LPFA's IMs are addressing key ESG risks/opportunities in its portfolio – greater clarity and transparency is required.
- LPFA must also push for **incentive structures that demonstrate better alignment with their investment beliefs** on ESG issues and with their long-term investment horizon.

LPFA's expectations on RI are:

1. Greater alignment with their long-term interests including a specific focus on incentive structures and voting rights.
2. Systematic integration of ESG analysis throughout the investment process.
3. Portfolio-specific ESG risk and opportunity identification and management.
4. Greater clarity and transparency in ESG reporting.

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1.1. REVIEWING YOUR RI EXPECTATIONS

As a starting point, AOs should:

- **Ensure that the fundamental rationale for pursuing RI is clearly understood.** Investment beliefs on the link between ESG factors and financial performance and expectations relating to the corporate responsibility of investee entities should be clearly stated. Considerations of timescale are also important as ESG factors are particularly significant for long-term investment performance.

- **Familiarise themselves with their RI policy[1] and voting and engagement policy.**

- **Consider whether they would be willing to assume an external manager's own RI policies.** External managers may not have the capacity to develop a customised RI policy for a specific mandate and may consider their own policy to be sufficient.

- **Consider expectations for an IM's approach to relevant principles, policies, standards or codes of conduct** and whether this reflects the AO's own approach or stated commitments. Being a PRI signatory is a signal that a manager is committed to integrating ESG factors into their investment processes. However, approaches to implementing the Principles differ widely. In order to understand a manager's approach fully, AOs should seek specific information in addition to establishing whether a manager is a PRI signatory. See Appendix I for examples of international standards and codes that are commonly cited as indicators of global best practice.

- **Consider the extent to which ESG-related expectations are a contributing factor to the selection process or a deciding factor.** An AO may be willing to select a manager that does not meet its ESG-related expectations if the manager is committed to improving their ESG processes post-selection. In this situation, the AO may need to develop structured processes for monitoring and engaging with the manager in order to measure and ensure progress over a predefined period.

Investors in pooled investment vehicles may have limited ability to influence the RI policy or governance for a pooled fund after they have made the investment decision. It is therefore particularly important to ask appropriate questions during manager selection to ensure that the IM selected is aligned with the AO's expectations. After investment, AOs can continue dialogue with the manager and work with other investors to signal the on-going importance of RI and set the context for subsequent investments.

EXAMPLES OF POLICIES, RI APPROACH AND STANDARDS:

PGGM's (IM, Netherlands) RI policy clearly articulates their investment beliefs and the cornerstones of their policy, and links these dimensions to their investment strategy, activities and organisational structure. A comprehensive policy helps PGGM translate their beliefs into operational procedures and practical expectations that are applied to direct investments and communicated to fund managers for indirect investments.

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Unipension (AO, Denmark) undertakes a norms-based approach to RI and emphasizes the importance of engaging with companies to influence change on ESG factors. They act as active owners of their investments in which goal-oriented dialogue is prioritised over exclusion. They cast votes on all listed shares and on listed corporate bonds in the special circumstances when voting is possible.

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Catholic Superannuation Fund (AO, Australia) has developed an Implementation Plan (the "RI Plan") as part of the implementation of their RI policy. The RI plan includes a framework for measuring progress and annual reporting to the investment committee on the outcomes. The RI Plan:

- Has been developed to ensure that Catholic Super invests in a sustainable way that reflects its investment beliefs as set out in the Investment and RI policy documents.
- Impacts different stages of the decision-making process, including identifying ESG-related issues for strategy and asset allocation decisions, manager review and selection.
- Defines specific actions that can be taken at the portfolio level, as well as wider actions that might involve collaboration with other industry agents and funds, both at the local and international level.

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The Financial Services Council (FSC) (Australia) is in the process of developing standards which will require Australian superannuation fund providers to implement and disclose ESG risk management policies. The ESG risk management section in this document discusses possible subjects for an ESG policy.

FSC aims to finalise the standards by February 2013. *A draft of the standards is available here.*

1. For guidance on developing a RI policy, please see the PRI guide to 'How to write an RI policy'.

1.2. SETTING EXPECTATIONS FOR HOW A MANAGER IDENTIFIES AND MANAGES ESG FACTORS IN THE PORTFOLIO

AOs should identify what expectations they have for:

- **The skills, competencies and experience of individuals charged with implementing RI procedures** (e.g. ESG specialists, investment analysts, portfolio managers). If the AO has internal investment teams, then they may seek to align their expectations for external managers with those of their internal investment teams.

- **Which ESG factors are areas of priority focus.** An AO whose investment strategies are influenced by certain values or themes, or who proactively excludes certain industries or companies, will require their managers to have policies and practices that can accommodate these requirements.

- **How ESG factors are incorporated into the investment process.** During the manager selection process, the candidate manager should be able to clearly explain how ESG factors are identified, how they manifest as investment risks and opportunities, how they are relevant to a particular investment strategy and portfolio and how they may affect investment decisions. In addition, asking about ESG factors at specific portfolio companies may help to make these practices more clear.

- **How ESG factors are incorporated into different asset classes (e.g. listed equity, fixed income, property) and investment strategies (e.g. active, passive, quantitative, fundamental).**

- **How the external manager integrates information from voting and engagement activities into investment analysis.** The process for using information may differ if an AO undertakes voting and/or engagement activities themselves or hires specialist firms to undertake these activities. In the latter situation, it is important that the AO shares this information with their IM in order to inform the IM's investment decisions.

EXAMPLES OF IDENTIFYING AND MANAGING ESG FACTORS IN PORTFOLIO:

The **PRI Initiative's** Integrated analysis: how investors are addressing ESG factors in fundamental equity valuation paper describes a step-by-step process for integrating ESG factors into fundamental stock analysis. This document offers insight on the investment analysis processes that AOs may expect their managers to undertake. It also includes examples of meaningful ESG practices undertaken by industry leaders. The document can help AOs identify and communicate the types of practices they expect of their fund managers.

Click here to read more [link pending]

The **PRI Initiative's** LP guide provides guidance for private equity limited partners seeking to ensure that their general partners to consistently and effectively identify and manage material ESG risks and opportunities. This resources provides guidance for how an LP might integrate ESG considerations into investment policy and investment decisions, ownership activities and disclosures sought from a GP and underlying portfolio companies.

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APG's (IM, Netherlands) approach to integrating ESG factors for each asset class identifies and addresses ESG factors that are specific to the investment strategy. For example, at the end of 2011 as part of its listed equity Global Emerging Market strategy, APG visited eight companies in Russia and met policymakers, Transparency International and Standard and Poor's to understand and contribute to better corporate governance standards in Russia.

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CalSTRS (AO, US) has an investment policy that identifies a list of 21 risk factors that should be considered when making an investment decision for an investment in any asset class across the globe. The list does not attempt to identify all forms of risk that are appropriate to consider in a given investment; however it provides a framework of factors that might be overlooked, for example: monetary transparency, fiscal transparency, data dissemination, corporate governance, respect for human rights, respect for political and environmental rights. CalSTRS requires all their fund managers, across each asset class, to assess these risk factors when making investment decisions on their behalf.

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Sarasin & Partners (IM, UK) has developed a framework which demonstrates how information analysed before investment feeds into activities after the investment decision has been made (i.e. monitoring, engagement and voting). This framework also demonstrates how information from these activities feeds into assessment of material risks and opportunities. This helps to provide assurance that ESG factors are integrated in a transparent and rigorous way.

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1.3. SETTING EXPECTATIONS FOR HOW A MANAGER UNDERTAKES VOTING AND ENGAGEMENT ACTIVITIES

If an AO chooses to have their manager undertake voting and engagement activities on their behalf, they may consider the points below. These points are directed at listed equity investments.

- **Defining expectations for the alignment of engagement and/or voting activities.** When an AO delegates engagement and voting activities to multiple IMs, there is a risk that these IMs may vote or engage inconsistently on ESG issues or with companies. One approach to mitigate this risk is for AOs to require IMs to act in alignment with the AO's voting and engagement policy/guidelines/expectations.

- **Decide whether it is important if the IM outsources voting and engagement activities or undertakes them in-house.** A manager that undertakes voting and engagement activities in-house will benefit from being able to integrate the information and outcome of these activities with investment decision-making. On the other hand an IM may choose to outsource voting and engagement activities to ensure that they are conducted by specialists and in order to concentrate on their own areas of expertise.

- **Define expectations for voting and/or engagement processes** including:
  - how relevant standards, codes of conduct and principles are incorporated into these activities,
  - how information from voting and engagement activities feeds into investment decisions,
  - what issues/industries they wish their manager to engage on/with, and
  - escalation strategies when an engagement is unsuccessful.

- **Decide if a manager is adequately resourced to be involved in constructive engagements.** Generating the desired outcomes for an engagement is a challenging task. An AO should consider whether their expectations for engagement outcomes are feasible given a manager's internal capability or access to external resources.

If an AO chooses to undertake voting and engagement activities themselves or outsource these activities to a service provider (SP), they may consider the following:

- Expectations for how their IM may provide information to help inform the AO's/SP's voting and engagement activities.

- If and how the AO/SP will share information from their voting and engagement activities with their IM in order to inform their investment decisions.

EXAMPLES OF AO VOTING AND ENGAGEMENT ACTIVITIES:

The **National Pensions Reserve Fund (NPRF) (AO, Ireland)** has a high level of passive equity management and therefore focus their RI efforts on active ownership. From the establishment of the fund, NPRF delegated all voting and engagement activities to their external managers. However, this approach proved to be challenging as NPRF's managers had differing approaches to voting. In addition, engagement was taking place at a basic or ad-hoc level by just a small number of managers. When NPRF came under significant scrutiny regarding a number of Sudan-related holdings, both portfolio managers and investee companies were responsive to their information requests but it became clear that NPRF did not have the necessary means to engage on a larger scale.

As NPRF learned more about the processes involved in voting and engagement, it concluded that the optimal approach would be to combine voting and engagement activities, where the information and outcomes of these activities would feed into voting decisions. Furthermore, outsourcing was an obvious choice since bringing voting and engagement in-house would require significant resources and a dedicated team, both of which were not going to be possible. As a result NPRF appointed an engagement overlay SP to carry out these activities.

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EAPF (AO, UK) has a voting policy which guides their managers on a range of environmental issues. EAPF allows their fund managers to decide how to vote in most cases. EAPF aims to vote on all environmental resolutions in the UK, Europe and North America – and, where practical, worldwide.

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Fonds de Réserve pour les Retraites (FRR) (AO, France) delegates its voting rights to its fund managers. In 2005, FRR developed proxy voting guidelines and mandates were awarded, in part, based on the ability of managers to comply with these guidelines.

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EXAMPLES OF IM VOTING AND ENGAGEMENT ACTIVITIES:

AXA Investment Managers' (IM, France) approach to engagement involves regular discussions with company management on topics such as the company's strategy, operational performance and management of ESG drivers. AXA's engagement framework is comprised of three pillars – issue prioritisation (e.g. relevance to client, client exposure to risk), ability to influence (e.g. relationship with company, opportunities to collaborate with other investors) and outcomes (risk-return benefit to clients). This framework is linked with possible actions such as voting for or against resolutions at company meetings, collective action with other shareholders and direct meetings with board members.

Click here to learn more about AXA IM's engagement framework

Click here to learn more about AXA IM's approach to voting

BC Investment Management Corporation (bcIMC) (IM, Canada) believes companies that do not give careful consideration to ESG issues risk failing to maximise shareholder value. In voting proxies and engaging with portfolio companies on ESG issues, bcIMC aims to encourage actions by a company's board of directors and management that they believe will add long-term value to shareholders. bcIMC will support resolutions and communicate with companies on issues that are likely to improve the firm's public image and reputation and reduce its exposure to risks.

bcIMC's corporate governance principles and proxy voting guidelines discusses a range of issues including management and director compensation, corporate responsibility and how proxy voting guidelines are applied to each issue.

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Along with their voting activities, **F&C Investments (IM, UK)** does a broad outreach to all companies in their client's portfolio. This broad outreach is complemented by in-depth dialogue with selected companies on ESG issues that are identified as having a material impact on their long-term performance. F&C's RI report provides an overview of their voting and engagement approach and examples of these activities.

Click here to read more

RobecoSAM (IM, Netherlands) bases its voting policy on the International Corporate Governance Network (ICGN) principles. RobecoSAM focuses its engagement activities on companies in which they have a substantial interest and/or in which they have invested considerable assets. The sustainability issues selected for discussion are those that impact the company's risks and opportunities, and as such, impact the company's value.

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1.4. SETTING EXPECTATIONS FOR HOW ESG FACTORS ARE REPORTED DURING INVESTMENT MONITORING

AOs may consider the following:

- **What ESG information should be provided by the IM and how frequently.** An AO should only ask for information that they intend to use and where they have internal ESG resources available to review and assess information.
- **If and how reporting on RI practices will be integrated with other reporting activities and into regular AO/IM meetings.**
- **Whether some reporting can be done in person or over phone calls.** There may be situations where sensitive data may not be disclosed in a formal report, but may be disclosed during meetings. Having a constructive bilateral dialogue between an AO and their IM can encourage mutual learning, and build trust and confidence.

EXAMPLES OF DISCLOSURE OF ESG FACTORS DURING INVESTMENT MONITORING:

The **PRI Initiative's** Reporting Framework requires fund managers to disclose how they approach RI in the asset classes they invest in. An AO may seek guidance from the Reporting Framework on what information they may request from their fund managers. Where this information is not already available in the fund manager's RI report on the PRI website, they may request fund managers to disclose the information. This will (i) align an AO's disclosure objectives with the PRI and (ii) reduce fund managers' reporting burden. The final Reporting Framework will be released in October 2013.

Click here to learn more about the PRI Reporting Framework

CDC (AO, UK) believes that close monitoring of their private equity fund managers will help improve their performance on ESG factors. In order to monitor ESG performance, CDC requires significant and meaningful disclosure of ESG information from its fund managers and their portfolio companies. At a minimum, CDC expects each fund with which its capital is invested to produce an annual ESG report in which ESG information and development impact data is reported. The development impact data is important as CDC seeks to demonstrate the outcomes its investments are having in emerging markets for local populations and economies. CDC also encourages information reported to be integrated into quarterly financial reporting although this is not obligatory. A key component of any strong ESG report is the identification of high priority issues and opportunities and regular updates to action plans that show progress on mitigating risks and realising opportunities.

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Stichting Philips Pensioenfonds (PPF) (AO, Netherlands) requires its managers to provide quarterly reports on the extent to which they are implementing PPF's RI policy. PPF monitors the ESG performance of their portfolios on a monthly basis using information that they receive from their ESG research providers. The information from monthly monitoring is used to assess and monitor their managers.

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II: MANAGER SELECTION

An AO's specific approach to manager selection will differ depending on their ESG-related expectations, decision-making criteria and investment strategy.

They should decide which requirements/questions should be included in RFPs and what information should be requested in questionnaires and during meetings with candidate managers.

To help enable AOs to have constructive dialogues with IMs, this section will propose:

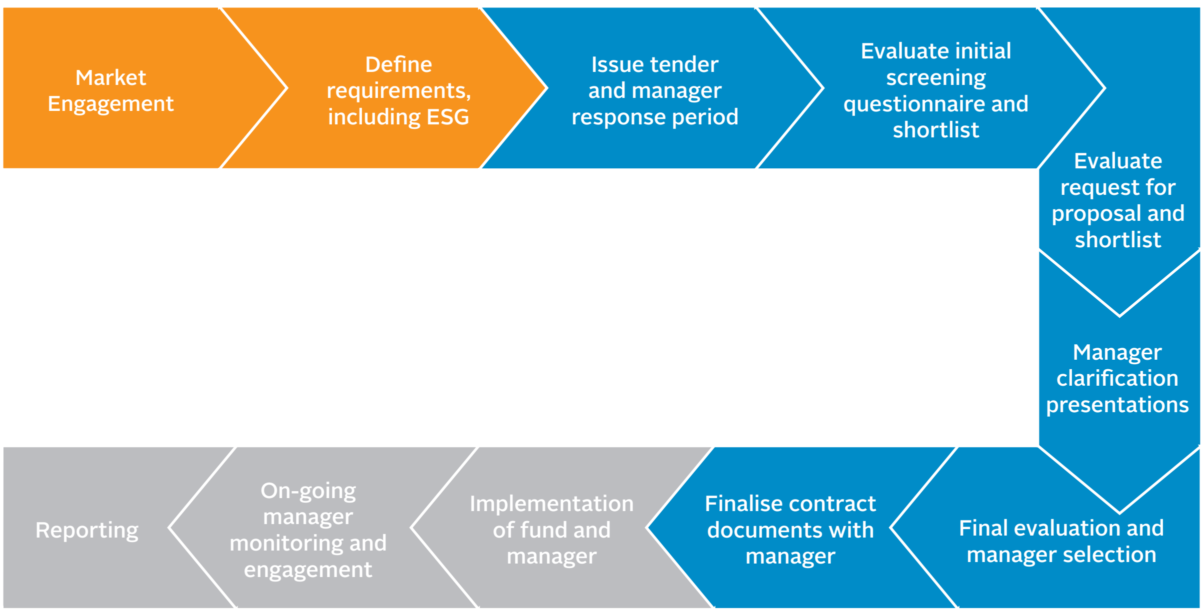
- Requirements or questions that an AO may include in RFPs, questionnaires or in discussions with IMs.
- Actions that an AO may undertake during follow-up discussions with IMs.
- Actions that an AO may take in order to request and analyse examples or evidence provided by IMs.

EXAMPLE OF A MANAGER SELECTION PROCESS

National Employment Savings Trust (NEST) (AO, UK)

In NEST's manager selection process, ESG-related requirements are defined in the beginning. ESG-related questions are included in the initial screening questionnaire, the RFP and during manager clarification meetings.

Figure 2: NEST's manager selection process



2.1. INCLUDING ESG-RELATED EXPECTATIONS IN RFPs, QUESTIONNAIRES AND DISCUSSIONS

ESG-related requirements should be incorporated into an RFP or similar document to frame the dialogue between an AO and the candidate manager.

EXAMPLE OF RFP REQUIREMENTS

Unipension (AO, Denmark) incorporates their RI expectations into the following RFP requirements:

1. The IM must be a PRI signatory or have similar guidelines in order to demonstrate the IM's commitment to RI.
2. Unipension's holdings must be held in a segregated mandate so that their manager is able to sell companies based on an exclusion list provided by Unipension.
3. Unipension will retain voting rights and the ability to directly engage with companies. It is important for Unipension to retain these rights in order to guarantee that all interactions with companies are aligned with Unipension's RI policy.

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While the broad ESG-related requirements/questions may be similar across asset classes and investment strategies, AOs should recognise the differences between asset classes and investment strategies and include specific requirements/questions that are relevant to the requested mandate. For instance, questions regarding proxy voting policies will only be relevant in the context of listed equity mandates, while issues around energy ratings will only be relevant to property investments or some infrastructure portfolios.

Concrete examples should be requested from managers to give them an opportunity to demonstrate how they identify and manage ESG factors in their investments. For example, if a manager has indicated that they have endorsed their local corporate governance code, ask how this endorsement is reflected in voting and investment decisions. As an additional step, AOs may ask IMs to comment on their approach to a recent ESG issue that is likely to have affected the IM's holdings. Approaches for requesting evidence/concrete examples will be discussed in the next section.

EXAMPLE QUESTIONS

Below is a collection of some questions that an AO may ask about a manager's ESG policies and procedures. Note that the voting and engagement questions below are only relevant to listed equity investment strategies.

RI policy and governance

- Please provide a copy of the IM's RI policy, and voting and engagement policy or other statement(s) setting out the manager's approach to RI.
- Describe how RI fits within the IM's investment philosophy.
- How are RI practices governed? How does the IM evaluate their current investments against their policy statement?
- Which person or what committee is responsible for the implementation of a RI programme? How are responsibilities assigned?
- What principles, policies, standards or codes of conduct has the manager signed up to? How does the manager intend to fulfil/improve their implementation of these initiatives?
- What public disclosures does the IM make about its RI/voting policies and outcomes?

ESG resources

- What internal or external skills/expertise/research does the manager use to identify and assess ESG risks and opportunities relevant to prospective and actual investments?
- How are portfolio managers incentivised to incorporate ESG factors?
- How does the IM share best practice across teams and across all investment staff?

Incorporation of ESG factors in investment analysis and decision-making

- How are ESG factors incorporated into investment analysis and decision-making processes? (e.g. asset allocation, definition of the investable universe, fundamental or sector analysis, portfolio construction, stock selection, etc.)
- How do you use ESG information to identify investment risks and opportunities or opportunities for engagement? How does this information impact investment decisions?
- How do you consider ESG factors in your analysis of a country's economic growth and macro themes that may impact a country such as resource security?
- Do you assess how ESG factors affect industries, for example, through changing consumer preferences or regulatory change such as environmental legislation?
- How do you assess a company's ability to identify and manage ESG-related risks and opportunities?
- How would you respond if you identified under-managed ESG risks within the investment? (e.g. engage with the company to influence change, change stock weighting)
- How do you integrate ESG factors into the financial valuation of an investment?
- How do you approach the analysis of investment risks that may have a low probability but a severe impact?

It important to note that some questions regarding integration of ESG factors will only generate meaningful responses if they are posed in conjunction with concrete examples. Please see the next section for guidance on how to request evidence and/or concrete examples.

Voting and engagement

- Describe the manager's approach to making voting decisions. Does the manager delegate decision-making? Who is responsible for the final decision? What does the manager do if there are internal conflicts on voting direction?
- How does the manager ensure that clients' specific voting policies and guidelines are followed?
- Describe the manager's approach to engagement. How do they define, plan and measure engagement? How do they select engagement topics/sectors/companies? How does the information gathered through engagement impact investment decisions? Does the manager have escalation strategies for when an engagement is unsuccessful?

Monitoring

- How does the manager communicate their RI approach to their stakeholders (e.g. investors, staff, consultants, service providers, intermediaries)?
- How often and through what mediums (e.g. meetings, written reports) are RI activities reported to AOs?
- Describe your standard reporting routines. Please provide an example of your monthly, quarterly and/or annual report for the fund.

SUGGESTED ACTIONS DURING MANAGER SELECTION MEETINGS

During later stages of the manager selection process, an AO may meet with candidate managers to follow up on the information gathered in previous stages or to gain a deeper understanding of their processes.

A site visit and/or conference calls to meet the key decision-makers in the candidate managers' investment team could be organised. This may include those responsible for the portfolio on a day-to-day basis, the ESG specialist and the client contact.

During the meetings, an AO could ask the same questions of different decision-makers to assess the degree of internal embedding and coordination of RI practices.

EXAMPLE OF ESG-RELATED QUESTIONS INCLUDED IN RFPS:

This is an excerpt from **Strathclyde Pension Fund's (AO, UK)** RFP document which includes ESG-related questions and criteria for evaluating these questions.

Criteria

1. These scores will form the basis of the RFP score (out of 50) given to your submission and we ask that you provide full, detailed answers to each. The reader should be able to elicit all of the key facts and points differentiating your approach from this section.
2. The responses to each of the questions listed under the criteria headings will each be scored out of 10. They will be combined with equal weighting to generate the total score out of 50.
3. Please limit the word count of the response to each individual question to 2,000 words.

Process (score out of 10) (People, philosophy, corporate capability and fees constitute the other sections to be scored)

Please describe your investment process in detail as it would apply to the management of this mandate, outlining exactly how your global equity portfolios are constructed, from idea generation through to the purchase or sale of individual positions and the management of risk. Your response should cover:

- sources of company/sector research including any use of screening or quantitative techniques;
- your ESG resources and how these will be incorporated into managing this mandate (note that the Strathclyde Pension Fund is a signatory to PRI);
- the interaction of research and portfolio construction in respect of the proposed strategy;
- how investment decisions are made; and
- how scalable the proposed strategy is and whether you have set hard or indicative capacity limits.

Appendix A

Please note that this information is being collected for information purposes only. Answers to these questions will not form part of the scoring process for this RFP.

Environmental, Social and Governance Issues

a. Please provide an outline of your corporate governance and voting policy. What proportion of stocks in your proposed portfolio would you expect to vote?

b. For the proposed mandate, are you able to accommodate voting policies aligned with third party agencies? Would this work for pooled investments?

c. How would you report ESG issues to the client?

d. In respect of the proposed strategy, has your firm published the extent of its compliance with the Financial Reporting Council's UK Stewardship Code? How can we access this information?

e. Is your firm a signatory to PRI?

Class Actions

a. What is your policy on initiating or joining a class action on behalf of your clients that invest in the proposed strategy?

b. What has been your experience to date on this issue, in relation to the mandate being considered?

EXAMPLES OF MANAGER SELECTION QUESTIONS:

AOs can review the **PRI Initiative's** Reporting Framework's direct implementation supplements for guidance on detailed questions that are asset class specific.

Click here to read more

CDC's (AO, UK) ESG toolkit provides example questions AOs can ask to assess an IMs ESG management system.

Click here to read more

EXAMPLES OF QUESTIONS ASKED BY AN AO INVESTED IN POOLED AND PASSIVE FUNDS:

The **National Employment Savings Trust (NEST) (AO, UK)** selects and structures their manager selection questions carefully to take into account their role as a pooled and passive investor. Below are some example questions they include in their selection processes:

- Does the manager have documented policies?
- How does the manager fulfil their commitments to codes and initiatives?
- Will the fund manager allow NEST to vote their own shares or allow NEST to provide input into the voting processes?
- Does the manager have a clear engagement policy and process?
- Does the manager offer good quality reporting?

NEST requires candidate managers to provide evidence and examples to support their responses.

Click here to read more

2.2. REQUESTING EVIDENCE AND/OR CONCRETE EXAMPLES

The way ESG factors are integrated into investment activities will differ by asset class and investment strategy. In order to gain meaningful understanding about a candidate manager's policies and processes, an AO could request evidence or concrete examples about how specific ESG factors impact a prospective or current investment.

Note the discussion below is most relevant to AOs who place importance on integrating ESG information into investment activities. However, some of this material may be adapted for other uses of ESG information (e.g. screening, thematic investing).

The purpose of requesting evidence or concrete examples is to assess whether a manager is effectively identifying ESG risks and opportunities in an individual holding in a way that is aligned with the AO's ESG expectations.

APPROACHES FOR USING EVIDENCE OR CONCRETE EXAMPLES IN DISCUSSIONS

Below are some suggested approaches for AOs wanting to use evidence and/or concrete examples in their discussions. Note that these points are specific to listed equity mandates, but may be adapted for other mandates.

- A candidate manager may have prepared evidence and/or concrete examples to support their responses. In this case, AOs should be prepared to ask probing questions to examine if the ESG practices undertaken in this example are applied consistently to other comparable situations.
- An AO could consider discussing examples of high profile ESG-related events such as BP Deepwater Horizon or the Lonmin mine strikes. However, it is important to extend beyond these anecdotal discussions and discuss the way an IM applies a systematic approach to relevant issues across different sectors.
- An AO could consider preparing examples to discuss with the candidate manager. They could select an example of a company/sector/region that the manager invests in and examples of what the manager does not invest in. This will enable them to examine the manager's decision-making process. If such an approach is taken, the manager should be informed before the discussion so that they are well prepared.

Regardless of the approach used, AOs could prepare themselves for these discussions by conducting research on the ESG factors that impact the selected examples, bearing in mind the characteristics of the mandate envisaged. They may look to external research providers/sources to identify and understand the extent to which ESG factors influence the selected example.

QUESTIONS ABOUT EVIDENCE OR EXAMPLES

An AO should be prepared to ask questions such as:

- What ESG factors were/are relevant to the investment company/sector and why?
- How does the manager decide whether an ESG factor is sufficiently significant to warrant further analysis?
- To what extent did/will the identified ESG factors impact the weighting of a stock? How was/is this weighting decided? How might this affect portfolio construction?

AOs could also pose the example questions listed in the previous section.

RESOURCES TO FACILITATE THE USE OF CONCRETE EXAMPLES:

The Co-operative Asset Management's (IM, UK) ESG assessment includes scores on three indicators: the extent to which a company is impacted by environmental or social factors, the ability of company management to address ESG risks and opportunities, and how the company's corporate governance structure and practices contribute to company value.

In the section on "Focus on Integration" of their RI report, Co-op Asset Management provides examples of companies where ESG factors were integrated into the research process. These examples include (i) information on which ESG factor impacted the company, (ii) what process and actions were taken by the investment team and (iii) how these processes and actions impacted the stock's fundamental analysis. This framework could be useful for an AO seeking to incorporate concrete examples in their discussions with candidate managers.

Click here to read more

The **Australian Council of Superannuation Investors (ACSI)** and **Financial Services Council (Australia)** have developed ESG reporting guidelines which aim to inform companies on how to report on ESG factors in a manner that is suitable to their own particular circumstances and industry environment. It also helps investors understand how specific ESG factors can impact investment performance.

Click here to read more

2.3. SOME APPROACHES FOR EVALUATING POTENTIAL MANAGERS

Each AO should have a manager evaluation approach that is suitable to their investment strategy. Regardless of approach, an AO should apply their ESG-related expectations or decision criteria to evaluate the information gathered from the selection process. For example, if an AO expects a manager to participate in or endorse specific ESG-related principles, codes of conduct, or initiatives, the AO should assess whether the manager is effectively fulfilling or implementing such initiatives.

In some situations, an AO may be willing to select a manager that does not meet its ESG-related expectations if the manager is committed to improving their ESG systems post-selection. In these cases, the AO may need to develop structured processes for monitoring the manager in order to measure and ensure progress.

EXAMPLES OF MANAGER SELECTION AND EVALUATION:

FRR (AO, France) works with over 30 asset managers worldwide (two-thirds of which are PRI signatories), and has allocated more than 40 investment mandates via a tender procedure. FRR follows a bidding procedure outlined by the French Public Procurement Act. This is a two-step procedure where candidates first answer a short quantitative questionnaire. Candidates are screened on their answers, and only those with the highest scores can submit a proposal.

During the second round proposals, potential managers are given a more complex qualitative questionnaire. After reviewing the second round answers FRR selects the winners (FRR requires oral interviews before the final selection) and begins conducting their verification due diligence. The successful IMs receive a mandate that specifies in detail the FRR's expectations (risk and return objectives, investment universe, voting proxies, etc.), and the manager's obligations throughout the management period (3 to 5 years for listed assets).

Click here to read more

AustralianSuper (AO, Australia)

Below is a diagram showing how AustralianSuper approaches selecting managers.

Figure 3: AustralianSuper's manager selection and monitoring process

- AustralianSuper works with their consultant to generate a long list of potential managers.
- An initial analysis is done on the long list after which a shortlist is developed.
- An RFP is sent to the short list of managers. The RFP topics and number of questions associated to each topic are shown below. Each question aims to understand one or more of these three questions –
  i. how does the manager make money?
  ii. do we trust them? and
  iii. is this the right time to investment with them?

Figure 4: RFP topics

Order	Topic	No. of Questions
1	Organisation	6
2	Staff	6
3	How do you make money?	16
4	Tax	1
5	ESG	4
6	Performance	7
7	Derivatives	2
8	Compliance & systems	6
9	Reporting	5
10	Custody	1
11	Fees	2
12	Cost management	3
13	Other	1

AustralianSuper asks potential managers the following ESG questions:

1. How do you consider ESG in the portfolio?
2. Outline your firm's approach to voting clients intent in matters of corporate governance and attach any appropriate policies.
3. Have you excluded stocks due to ESG issues?
4. Are you a signatory to the PRI?

III. MANAGER APPOINTMENT

After a manager is selected, an AO may negotiate and agree on a number of ESG-related terms and conditions. This section includes some samples of ESG contract terms that an AO may consider incorporating into their IMA.

It should be noted that including ESG-related terms in IMAs is not the only way to hold a manager accountable to the ESG policies and practices agreed upon during the appointment process. An AO may instead choose to focus on regular monitoring to ensure that their managers are consistently improving their implementation of the agreed upon ESG policies and practices.

A side letter agreement could be an alternative to writing specific ESG-related requirements into the IMA. Side letters form a legally enforceable understanding between two parties. They provide a formal record of the AO's wishes and the IM's intention to abide by them. Side letters could also be used to amend existing agreements.

AOs should consult their legal counsel regarding the objective and specific language to be used.

Below are some sample ESG-related clauses from industry bodies and PRI signatories. The example clauses included below do not address all of the expectations discussed in this document. AOs may wish to include other clauses that are specific to their contractual requirements.

EXAMPLES OF ESG-RELATED CLAUSES FROM THE ICGN MODEL MANDATE INITIATIVE

The **ICGN** model mandate aims to help AOs in considering the expectations they can have of their fund managers and how they can formulate their contracts or mandates so that fund managers can deliver on those expectations. Below are some example clauses from the model mandate initiative.

For more information or for the complete collection of the clauses, please visit the *ICGN website* or contact *kerrie.waring@icgn.org*.

PROPOSED MODEL TERMS FOR MONITORING ESG

The Manager will have a process for monitoring current or potential investments in relation to relevant long-term factors such as ESG concerns. The Manager will ensure that its staff apply due care and diligence to applying this monitoring process, including considering the extent to which such long-term factors generate investment risks or opportunities.

PROPOSED MODEL TERMS FOR ONGOING DUE DILIGENCE

The Manager will facilitate access by the Client to its staff and systems such that the Client can gain assurance on an on-going basis that the Manager is appropriately implementing the Client's responsible investment policy set … [as agreed with the Client in schedule XX] .., monitoring key longer-term risks and integrating such factors into its investment and risk management decision-making.

PROPOSED MODEL TERMS FOR VOTING

Alternative 1 [where Client or its agent has voting control]
The Manager will enable the Client or its designated agent to direct the exercise of any voting rights attaching to the Portfolio investments.

Alternative 2 [where Manager votes according to Client guidelines]
The Manager will procure the exercise of any voting rights attaching to the Portfolio investments in accordance with the Client's expressed voting guidelines, with a view to achieving best practice standards of corporate governance and equity stewardship and with the aim of adding value to, and/or preserving value in, the Portfolio, as well as reducing unwanted risk exposures.

Alternative 3 [where voting control delegated the Manager]
The Manager will procure the exercise of all voting rights attached to the Portfolio investments on the Client's behalf, in accordance with the Manager's voting policy and any market-specific guidelines approved by the Client. The Client reserves the right to rescind, upon [one day's] advance written notice, the Manager's authority to make voting decisions for specific companies, issues or time periods. The Manager will use best endeavours to facilitate such Client voting decisions to be implemented. The Manager will have in place appropriate policies to manage any conflicts of interest in relation to voting matters and shall report at least quarterly on all votes involving companies where the Manager or an affiliate have a contractual relationship or other material financial interest.

PROPOSED MODEL TERMS FOR REPORTING

In addition to reporting requirements set forth elsewhere, the Manager will prepare no later than x business days after the end of the relevant [quarter], reports covering the reporting period, including:

Standards and High Level Commitment

- *Compliance with the policies and standards … [as agreed with the Client in schedule XX] .., including any instances where those policies and standards were set aside in order to achieve investment objectives;*
- *Governance structures at the fund manager and an explanation for any non-appliance of relevant best practice standards;*

Monitoring

- *The key material ESG concerns associated with Portfolio investments and an explanation how the Manager sought to identify, monitor and manage them;*

Stewardship and voting

- *A brief summary of the reporting period stewardship activities, including evidence of the effectiveness of those activities;*

Full disclosure of voting activities over the reporting period, including an explanation of any exercises of discretion under the Manager's or Client's voting guidelines and conflicts of interests.

EXAMPLES OF ESG-RELATED CLAUSES FROM UNIPENSION (DENMARK, AO)

PRI

Is the Investment Manager a signatory of the PRI? The Investment Manager shall notify the Fund immediately if the Investment Manager's status as a signatory to the PRI is terminated/ceases.

VOTING - EQUITIES

The voting rights in relation to investments in the Fund are to be exercised by the Fund. The Fund may appoint a third party entity as its agent to exercise the voting rights (the "Voting Agent"). The Fund shall notify the Investment Manager of the appointment of any such Voting Agent from time to time. The Investment Manager shall have an obligation to assist the Fund and/or the Voting Agent with the execution of the votes, if reasonably requested by the Fund or the Voting Agent.

VOTING - CORPORATE BONDS

The voting rights in relation to debt investments in the Fund (i.e. investments in bonds and bank loans) are to be exercised by the Investment Manager on behalf of the Fund.

The Investment Manager shall report the number of times the Investment Manager has exercised the voting rights in relation to debt investments in the Fund and into what favour the vote was given.

ENGAGEMENT

The engagement in relation to investments in the Fund regarding environmental, social and corporate governance issues are to be exercised by the Fund. The Fund may appoint a third party entity as its agent to do the engagement work.

CLASS ACTIONS

The Investment Manager shall provide factual documentation to the Fund in relation to the class action upon reasonable request from the Fund. For the avoidance of doubt the Investment Manager shall not initiate or participate in any legal proceedings on behalf of the Fund and shall not file claims or take any related actions on behalf of the Fund in regards to class action settlements related to securities currently or previously held in the Fund, nor shall the Investment Manager advise or assist in the evaluation, pursuit or settlement of such proceedings or claims. However, the Fund shall make arrangements for the filing of any class action proofs of claim.

EXCLUSION

The Fund must not make investments in companies breaching the ethical rules of the Fund. The list of such companies (the "Exclusion List") will be sent from the Fund or Administrator by e-mail to the Investment Manager from time to time. The e-mail including the attached Exclusion List shall constitute a valid notice and amendment regardless of Clause X and Y within the Agreement. In connection to the e-mail the Investment Manager has 7 Business Days to implement the Exclusion List within the investments of the Fund upon the day of the arrival of the e-mail.

EXAMPLES OF ESG-RELATED CLAUSES FROM ACSI

ACSI (SP, Australia) developed a guide for superannuation trustees on the consideration of ESG risks in listed companies. Appendix 3 of this guide includes draft clauses for investment management agreements or investment mandates. Below are the draft clauses.

1. INTRODUCTION

In accordance with the investment policy of the Fund and its strategic asset allocation, the Trustee invests part of the Fund's assets in Australian and overseas-based equities.

The Trustee regularly assesses and reviews the shareholdings in the context of performance, risk and return considerations.

The Trustee considers that some of these risks and opportunities are related to environmental, social and governance ("ESG") performance of the companies in which it invests.

The Trustee is a long-term investor and, as a consequence, it might face risks and miss opportunities that may otherwise be overlooked by its agents.

2. MANAGER MUST CONSIDER TRUSTEE'S ESG POLICY AND THE UN PRI

The Trustee has adopted an ESG policy that addresses the way in which it wishes to consider the risks and opportunities of ESG factors in investee companies. A copy of this policy will be supplied to the Manager on commencement of this Agreement. The Trustee expects the Manager to be aware of:

a. The Trustee's ESG policy.
b. The Trustee's concerns about the risks that long-term ESG and economic factors can impose on the Fund's investments and also of the longer-term investment opportunities that might arise from those factors.
c. The United Nations-supported Principles for Responsible Investment ("PRI") and the fact that the Trustee is a signatory to the PRI.

The Manager must have regard to, and use its best endeavours to act consistently with, the Trustee's ESG policy and the PRI.

3. MONITORING OF ESG EXPOSURES

At all times when monitoring ESG issues, the Trustee will act in the best financial interests of members of the Fund, as required by its legal obligations.

The Trustee expects the Manager to refer to relevant ESG risk and opportunity factors in its reporting and, in particular, expects the Manager to report to the Trustee (you may wish to state how often) about:

a. The Manager's ESG activities, including research, voting and engagement with companies, and
b. How the Manager integrates consideration of ESG issues into its investment analysis and decision-making processes.

The Trustee may also periodically ask the Manager to report on the Manager's approach to incorporating the UN PRI into its investment processes.

4. REVIEW OF TRUSTEE'S ESG POLICY

The Trustee will review its ESG policy from time to time to ensure that it continues to align with the Trustee's objectives with regard to the management of long-term investment risk and opportunities. The Trustee will supply to the Manager a copy of its ESG policy when it is amended.

Click here to read the report

IV. MANAGER MONITORING

An AO's objectives for manager monitoring will include:

- Assessing whether the appointed manager is managing the AO's portfolio in a way that is aligned with the agreed ESG policies and practices. This could include evaluating whether a manager is improving their systems for identifying and managing ESG factors, as agreed upon during the manager appointment process.

- Understanding if there are any material changes to the ESG risks and opportunities in the AO's portfolio.

- Remaining informed of any ESG-related incidents/events in the AO's portfolio. Note that the AO should agree with their appointed manager which incidents/events should be disclosed and how/when this information should be communicated.

AOs may also develop an evaluation framework to assess the extent to which their appointed manager is fulfilling their ESG-related expectations.

This section will:

- Propose actions that an AO may undertake to ensure that they receive the information needed to evaluate their manager's progress and the ESG-related performance of their portfolio.

- Offer guidance and examples for evaluating appointed managers.

4.1. INCLUDING ESG-RELATED EXPECTATIONS IN REPORTING AND DISCUSSIONS

AOs will have varying approaches for requesting information from their appointed managers which may include formal reporting and discussions between the AO and IM to follow up on the information disclosed in the report. The information that an AO requests during monitoring may be similar to the information requested during selection.

EXAMPLE OF INFORMATION TO REQUEST WHEN MONITORING MANAGERS

Scottish Widows Investment Partnership (SWIP) (IM, UK) has invested £4.2bn in segregated funds that are managed by external managers.

Below are example questions that SWIP sends to their external managers as part of their quarterly ESG monitoring. If SWIP has any issues with the responses, it will raise them with the manager for discussion. Note that the questions below are aligned with the questions in the PRI reporting framework.

- Please provide a description of how your governance, policies and strategies address RI and ESG issues.
- Do you have a policy or set of policies that makes specific reference to RI and if so, do they cover ESG issues?
- What percentage, by asset class, of your organisation's assets under active management internally integrate the consideration of RI/ESG issues in investment decision-making process – such as researching ESG information and/or constructing/managing portfolios – and to what extent?
- For listed equities, please indicate the ratio of proxy votes cast, either directly or via third parties (such as external service providers or investment managers) against those you could have cast, last year for at least one of the following measures:
  - By ballots item or resolution;
  - By meetings (e.g. AGMs, EGMs, special);
  - By listed assets under management.
- Do you pro-actively inform your listed companies of your rationale when you abstain or vote against management recommendations?
- Do you have a written engagement policy or other documents that direct engagement with listed equity and fixed income issuers; if so, do these policies address environmental, social and governance (ESG) issues?
- In total, how many listed equity and fixed income issuers did your organisation engage with or were engaged with on your organisation's behalf on ESG issues in the last year, by level of engagement (extensive, moderate or basic)?
- To what extent did you disclose, either to clients/beneficiaries or publicly, your policy and/or approach to incorporating ESG issues into investment analysis and decision-making processes in the last year?
- Did you disclose your voting policy last year?
  - Did you disclose you (proxy) voting record last year, and if so,
  - How much of your voting record did you disclose?
  - Did you disclose the explanations/ reasons for voting as you did?
  - How frequently did you disclose?

Click here to read more

REPORTING

The amount, frequency and type of information AOs request from IMs depend on the mandate, the agreed ESG policies and practices, and the AO's capacity to review the information. Below are some of the things AOs should keep in mind.

- At a minimum, reporting should cover all aspects of what was agreed upon in the IMA or other documents. RI reporting may be built into existing manager reporting obligations.
- Reporting requirements should be legally agreed upon before any commitments are made. It may be difficult to make changes to reporting requirements after legal documents are signed and the transfer of funds has taken place. If an AO requests additional information beyond what was agreed upon, they should be prepared to provide a justification.
- AOs could also ask to be kept informed of specific ESG incidents and how the manager or portfolio company will resolve them.
- If the manager is a PRI signatory, an AO may use the PRI Reporting Framework as a starting point to avoid duplicating reporting processes.
- An AO may need to decide if they require bespoke and mandate specific reporting from the appointed manager or if it is sufficient to receive a generic report that is sent to all the manager's clients.

EXAMPLE OF REPORTING

Christian Super (AO, Australia) requests bespoke reporting from IMs on particular ESG issues if the manager's standard reporting does not meet Christian Super's expectations. The fund can also request bespoke or additional reporting for specialized investments such as microfinance.

Click here to listen to a podcast by Tim Macready, CIO of Christian Super, to learn more

SUGGESTED ACTIONS FOR DISCUSSIONS WITH MANAGERS

An AO may meet with their appointed managers to follow up on information disclosed in reports and to discuss other issues. An AO could consider:

- Focusing on investments that represent a major part of its portfolio.
- Integrating the discussion on ESG performance with regular financial performance meetings. During these meetings, the AO should ensure they are meeting with the key decision-makers such as investment analysts, the portfolio manager as well as the ESG team.
- Working with an external research and engagement provider to (1) assess whether the appointed manager is systematically identifying and managing ESG risks and opportunities in the AO's portfolio and (2) analyse the ESG developments of companies in their portfolio.
- Identify (either directly or with the help of external analysis) two or three companies in the portfolio with specific and relevant ESG risks. Discuss the IM's assessment of those companies and of the specific ESG risks that those companies face. During these discussions, seek to understand how those risks have in practice been incorporated into the IM's investment decision-making. For related guidance, refer to the 'requesting evidence/ concrete examples' section of this guide.

EXAMPLES OF PRI SIGNATORIES WORKING WITH SPs TO ENGAGE WITH THEIR IMs ON ESG DEVELOPMENTS

EAPF (AO, UK) works with **Trucost (SP, UK)** to measure the environmental footprint of its equity investments and through this, monitors the effectiveness of its IMs' efforts to manage the environmental impacts of their equity holdings. EAPF encourages their equity managers to pay for the environmental footprint assessment so that the managers take ownership of the environmental outcomes of their equity portfolios. The footprints reveal which companies have the weakest disclosure and environmental performance relative to sector peers, and which contribute most to the fund's exposure to environmental costs.

Click here to read more

GES (SP, Sweden) works with **Strathclyde Pension Fund (AO, UK)** to monitor Strathclyde's fund managers' engagement activities, and how the information from these activities feeds into their IM's investment process.

- Together with Strathclyde, GES will set up a process based on international guidelines for ESG issues. This process will be used to identify companies that are systematically and severely breaching well-accepted international standards.
- GES will check Strathclyde's holdings in the underlying funds and report to them which companies were identified as breaching international standards. Strathclyde will decide if the identified companies are relevant for engagement based on their policy.
- GES then arranges engagement meetings with Strathclyde's IMs to present the engagement case(s) in the IM's portfolio. In these meetings the GES engagement managers will outline the long-term engagement objective and share information about the engagement case. The IMs are encouraged to exert influence on the company to address the ESG issue under scrutiny.
- GES will follow up in six months to assess the IM's progress - if the IM has assessed the case and taken any actions. This discussion will also include questions to assess if and how the IM is using this information in their investment processes.

In addition to company-specific engagement reports that Strathclyde can extract from GES' Engagement Forum, Strathclyde also receives regular reporting about GES' dialogue with the IMs and their progress. This includes minutes from the engagement meetings, evaluation of the IM's engagement performance and a rating of the IM's RI policy and engagement preparedness.

4.2. SOME APPROACHES FOR EVALUATING APPOINTED MANAGERS

This section provides examples of how some PRI signatories approach evaluating their appointed managers.

Regardless of approach, AOs seeking to help the appointed manager improve their systems for identifying and managing ESG factors should consider the following actions:

- Provide feedback on how the manager performed in the monitoring assessment. This feedback could include how the manager was rated and some key actions that the manager could take to improve their performance.
- Share good practices/standards with the manager.

EXAMPLES OF EVALUATION APPROACHES

The **Pension Protection Fund (PPF) (AO, UK)** has developed a RI rating system that is fully integrated into PPF's wider performance monitoring framework. PPF rates their managers' RI approach in five performance areas:

- Philosophy (e.g. does the manager consistently apply their RI policy at a strategy level?)
- Alignment (e.g. does the manager's incentive structure promote a long-term perspective?)
- ESG integration (e.g. is ESG research/data effectively 'plumbed' into investment processes and decision-making?)
- Stewardship (e.g. does the manager monitor ESG issues in the portfolio, and engage with company boards/underlying fund managers on ESG issues of concern?)
- Resources (e.g. does the manager dedicate appropriate resources to RI, such as staff or research?)

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Catholic Superannuation Fund (AO, Australia) has developed a framework with seven pillars to assess the ESG capabilities of their IMs by asset class. The seven pillars include policy, collaboration, research/capabilities, ESG integration process, voting, engagement and reporting.

Catholic Super has a three point ESG grading system of managers - leader, improver and laggard. Their assessment crosses the seven areas mentioned above. Using this framework and the information available, they categorise incumbent and existing managers into one of the three levels. Sometimes the manager may be rated as a laggard but with potential to be an 'improver' if they have plans to evolve their processes and make changes in the future. In new appointments, if a manager was rated as a laggard with no potential for improvement then this would act as a red flag and may preclude investment.

The process is qualitative and requires judgment on areas that are often challenging to ascertain, such as attitudes towards ESG, management support, the culture of the organisation and formulating a view on how things are likely to evolve in the future.

Click here to read more

AREAS FOR FURTHER WORK

Manager selection, appointment and monitoring remains a key area of discussion and debate in the RI industry. This guidance document provides a non-exhaustive collection of action points and examples from PRI signatories and industry associations. The purpose of the action points and examples is to stimulate discussion among AOs and IMs in order to develop and/or promote improved manager selection, appointment, monitoring and RI frameworks.

Below are some suggested areas for future research and knowledge sharing:

- The importance of timescales and performance measurement periods.
- Developing frameworks for manager monitoring.
- How to link ESG performance to incentives.

AOs and IMs are encouraged to share good practices and to collaborate with one another to address challenges and emerging issues.

The PRI hopes this document will continue to evolve over time. If you have a case study that you would like to contribute to aid further awareness of the manager selection appointment and monitoring processes, please contact info@unpri.org.

PREPARATION OF THIS DOCUMENT

This document was prepared by the PRI Secretariat with support from the PRI Small and Resource-Constrained work stream steering committee and a number of PRI signatories who shared their experiences and case studies with the PRI Secretariat.

The recommendations and suggestions it contains are those of the contributors and the PRI Secretariat. They should not be interpreted as representing the views of individual PRI signatories or the PRI Initiative as a whole. The PRI Secretariat would like to thank all contributors for the significant input to this document including:

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APPENDIX I: STANDARDS AND CODES

While the content in this tool is directed at AOs invested in listed equity, the PRI recognises that, with minimal adaptation this tool may also be relevant for other investment strategies. Resources applicable to a wider range of investment strategies have been included in this section.

CODES ON RESPONSIBLE INVESTMENT AND STEWARDSHIP

- *CFA Institute's Asset Manager Code of Professional Conduct*
- *Code for Responsible Investing by Institutional Investors in South Africa*
- *EFAMA Code for External Governance*
- *Eumedion best practices for engaged share-ownership*
- *ICGN Statement of Principles on Institutional Shareholder Responsibilities*
- *ICGN Global Corporate Governance Principles*
- *ICGN Securities Lending Code of Best Practice*
- *International Securities Lending Association stock borrowing and lending code of practice*
- *OECD's Principles on Corporate Governance*
- *Singapore's corporate governance code – statement on the role of shareholders*
- *Swiss Stewardship code*
- *UK Stewardship Code*

PROPERTY

- *Global Real Estate Sustainability Benchmark*

HEDGE FUNDS

- *Hedge Fund Standards Board standards*

PRIVATE EQUITY

- *EVCA Professional Standards Handbook*
- *Institutional Limited Partners Association Principles*
- *International Private Equity Valuation Guidelines*
- *Private Equity Growth Capital Council Guidelines for Responsible Investment*
- *The Guidelines Monitoring Group*

OUR UN PARTNERS

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

UN Global Compact
Launched in 2000, the United Nations Global Compact is a both a policy platform and a practical framework for companies that are committed to sustainability and responsible business practices. As a multi-stakeholder leadership initiative, it seeks to align business operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to catalyse actions in support of broader UN goals. With 7,000 corporate signatories in 135 countries, it is the world's largest voluntary corporate sustainability initiative.

More information: www.unglobalcompact.org

UNEP Finance Initiative
Innovative financing for sustainability

United Nations Global Compact