Principles for Responsible Investment

AN INTRODUCTION TO RESPONSIBLE INVESTMENT FOR ASSET OWNERS

UNEP FINANCE 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.

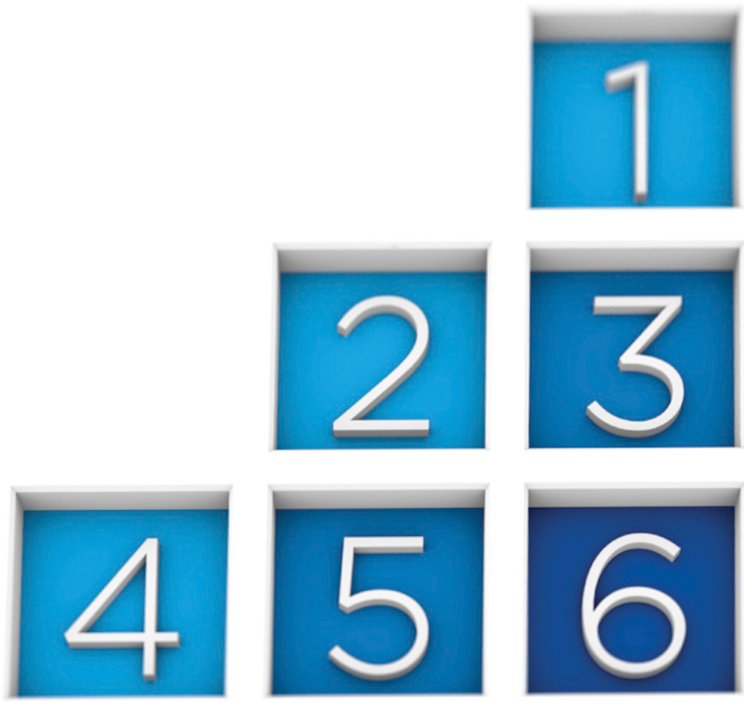
2 We will be active owners and incorporate ESG issues into our ownership policies and practices.

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.

CONTENTS

WHY INVEST RESPONSIBLY

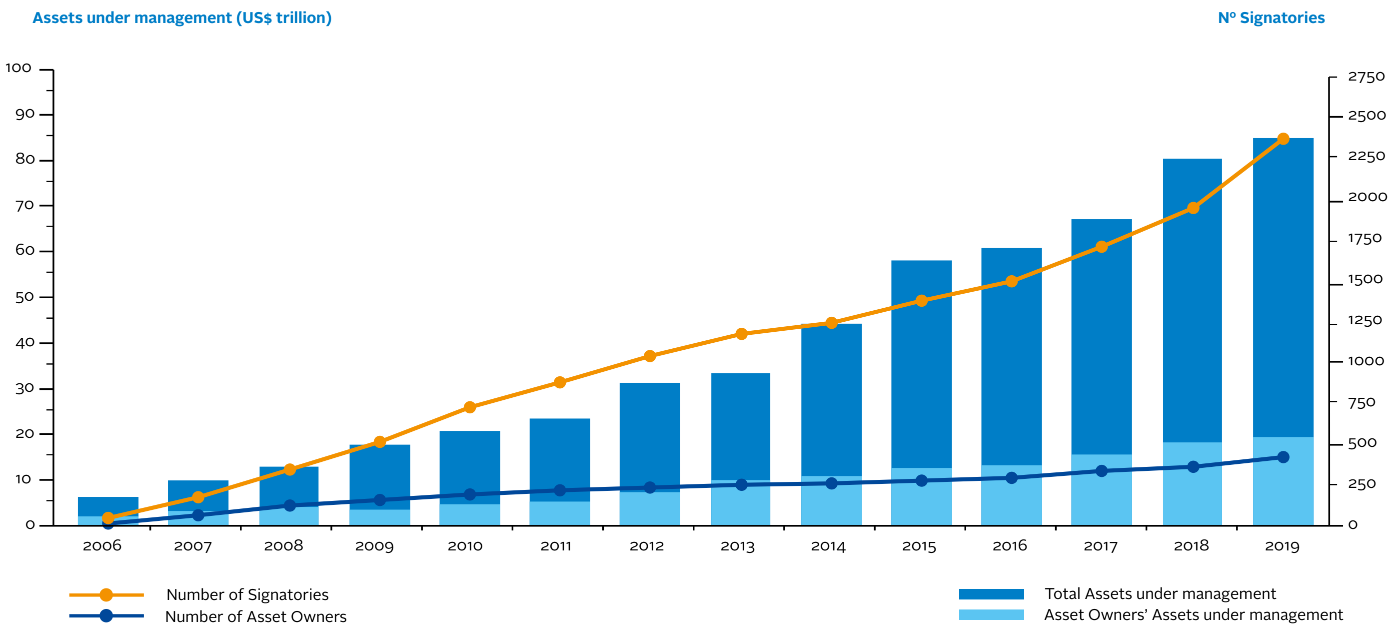
Responsible investment is a strategy and practice of incorporating environmental, social and governance (ESG) factors in investment decisions and active ownership. Examples of ESG factors include:

- environmental – climate change, water, resource scarcity, waste, biodiversity, etc.
- social – employee engagement, health and safety, worker and human rights, local communities, diversity, etc.
- governance – independent oversight, management systems, shareholder rights, remuneration etc.

In the decade since the launch of the Principles for Responsible Investment (PRI), responsible investment has entered the mainstream. The PRI itself has grown into a broad movement, representing and supporting over 2,000 financial institutions that manage in excess of US$80 trillion.

This document introduces some of the discipline's main concepts and methodologies, with selected examples of further resources provided throughout. Be sure to visit the PRI website to explore the full range of guides, case studies, videos, events and other services that the PRI offers.

Figure 1: PRI signatory growth since its inception (2006-2019)



THE LINK TO FINANCIAL PERFORMANCE

Responsible investment aims to align with an asset owner's main objectives. While for some asset owners, values – or an objective to create positive real-world – may be a primary focus, responsible investment generally is aimed at enhancing performance and achieving market-rate or better returns.

> "Only 10% of studies display a negative ESG-CFP relationship, with an overwhelming share of positive results."
>
> ESG & Corporate Financial Performance: Mapping the global landscape

When Deutsche Asset Management and the University of Hamburg analysed the more than 2,000 academic studies (and 60 meta studies) on how ESG factors affect corporate financial performance, they found "an overwhelming share of positive results" and just one in ten showing a negative relationship. The PRI's own work has also found a connection between ESG factors and shareholder returns.

> "After engagements have concluded successfully, we find target companies experience improved profitability."
>
> Local leads, backed by global scale: the drivers of successful engagement

Equally, two recent studies, Local leads, backed by global scale: the drivers of successful engagement, and How ESG engagement creates value for investors and companies, show that successful engagement (a form of active ownership) by investors with companies on ESG issues can create shareholder value. As the former study concludes: "After engagements have concluded successfully, we find target companies experience improved profitability, as measured by return on assets, and increased ownership by the lead investor who conducted the dialogue on behalf of the coalition."

A 21ST CENTURY APPROACH TO FIDUCIARY DUTY

As it is increasingly recognised that ESG issues are often financially material in the short- and long-term, they are an important part of investors' approach to fulfilling their fiduciary duty to beneficiaries. The PRI's Fiduciary duty in the 21st century programme, examining fiduciary duty and other investor obligations around the world, has found that far from fiduciary duty being a barrier to considering ESG issues, investors' legal obligation towards beneficiaries can be a key reason to embed sustainability considerations in their investment decisions. This is being reflected by a growing number of policy makers and regulators worldwide.

KEY CONSIDERATIONS

- Financially-material ESG factors should be incorporated in investment decision making.
- Investors should consider ESG factors consistent with the time frame of the obligation.
- Investors should understand and incorporate the sustainability preferences of their clients and/or beneficiaries.
- Investors should consider disclosing the process followed.

Fiduciary duties and other regulations also focus on active ownership. Some countries have launched stewardship codes that provide soft law expectations and guidance for investors to be responsible, active owners of the shares they hold in listed companies. The OECD guidelines for multinational enterprises, which cover global investors, also indicate the need for investors to prevent or mitigate potential negative effects of the business activities they are linked to, either through their investments or active ownership. Public and government expectations about responsible investment and its contribution to sustainable development is expected to grow.

Fiduciary duty in the 21st century

HOW TO EMBED RESPONSIBLE INVESTMENT IN THE INVESTMENT PROCESS

To effectively include ESG factors in investment decisions and active ownership, such approaches must be firmly embedded in the entire investment process. Stages may include:

1. Mission, vision and statement of organisational purpose
2. Investment strategy
3. Investment policy
   a. Integrated responsible investment policy
   b. Separate responsible investment policy
4. Strategic asset allocation
5. Mandate development per asset class
6. In-house versus external management
   a. In-house: portfolio construction and investment selection
   b. External: selection, appointment and monitoring
7. Active ownership (voting, engagement and litigation)

1. MISSION, VISION AND STATEMENT OF ORGANISATIONAL PURPOSE

To identify and explain a mission, vision or statement of purpose, an asset owner's board could survey or otherwise seek to understand the views of their beneficiaries/ clients/savers on ESG factors, and their expectations for responsible investment. This kind of wider stakeholder involvement is something governments are increasingly introducing regulations to enforce.

The Sustainable Development Goals (SDGs) provide a globally agreed framework to make the world more sustainable by 2030, calling on the private sector in particular for help in doing so. The PRI's SDG Investment Case outlines five ways in which sustainability and the SDG framework are relevant to investors.

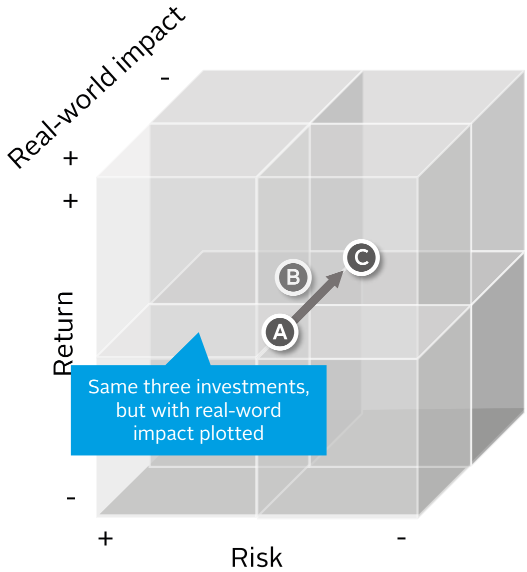
The SDG investment case

2. INVESTMENT STRATEGY

In forming their investment strategy, asset owners usually make high-level decisions on areas such as market efficiency, modern portfolio theory, the potential for outperformance and making investment decisions based on data or future scenario planning.

In its investment strategy guidance, the PRI expands on the two-dimensional concept of risk and return by outlining a third dimension of real-world impact. This three-dimensional view is one way of embedding a high-level commitment to ESG factors in an investment strategy. (Read more in the *Responsible investment methodologies* section.)

Figure 2: For the investors that makes considerations beyond strictly financial benefits, real-world impact presents an order of preference not otherwise evident.



How to craft an investment strategy

3. INVESTMENT POLICY

By formalising an investment process in a policy, asset owners differentiate emotions from facts when making investment decisions, keeping a relentless focus on performing in line with their investment strategy in an evidence-based manner. The focus is on how high-level commitments and the investment strategy is put into practice.

An investment policy usually highlights whether an asset owner wants to manage its assets in-house or outsource to external managers, as well as whether assets will be actively or passively managed, and which benchmarks, if any, will be used.

INTEGRATED INVESTMENT POLICY

Asset owners can develop and revise their core investment policy to incorporate all long-term factors, thus aligning ESG factors with mainstream policy considerations.

Investment policy: process and practice

SEPARATE RESPONSIBLE INVESTMENT POLICY

Not all asset owners are ready to incorporate their responsible investment objectives into their mission, vision, investment strategy or investment policy. However, they may develop a separate responsible investment policy, which can be a good start. If using a separate policy, it is particularly important to make sure there is alignment in the implementation phase. This will require board-level commitment and dedicated RI/ESG staff with sufficient authority to execute the policy.

Writing a responsible investment policy

4. STRATEGIC ASSET ALLOCATION

Strategic asset allocation (SAA) decisions have historically been based on data about the risk-return profile across asset classes, but with fast, global economic changes taking place, asset owners are increasingly using forward-looking scenarios.

This raises the question of if and how ESG factors, the SDGs and sustainability in general should be incorporated into the SAA process and scenario analysis.

5. MANDATE DEVELOPMENT PER ASSET CLASS

Before moving from SAA to portfolio construction or manager selection, asset owners are increasingly developing clear mandates for investment managers to follow across asset classes. These should include how ESG factors will be embedded into investment decisions and through active ownership.

Larger asset owners usually develop more detailed mandates and can even opt for customised solutions, while smaller asset owners usually have more generic mandates that allow for a selection of off-the-shelf products and services.

In listed equities and fixed income, existing decisions (such as: global versus regional portfolio, exposure to emerging markets, large-cap only or small- and mid-cap, active or passive, alternative or smart beta, diversified or concentrated portfolio, benchmarks and tracking errors) should be complemented by decisions about ESG approaches such as:

- exclusion/norms-based screening
- negative screening
- positive/best-in-class screening
- fundamental integration
- factor investing
- ESG tilts
- thematic investing
- impact investing
- active ownership (voting, engagement and litigation).

(Read more in the *Responsible investment methodologies* section.)

In private equity, alongside considering approaches such as leveraged buyout, growth, venture capital, co-investment, emerging market exposure and fund-of-funds, the mandate could specify aspects such as:

- whether a norms-based exclusion policy applies;
- how ESG/sustainability should be part of the portfolio company selection process;
- if and how ESG incidents should be reported;
- whether the asset owner wants to be part of a Limited Partner Advisory Committee.

A similar process of mandate development is relevant for all asset classes.

6. IN-HOUSE VERSUS EXTERNAL MANAGEMENT

Once the SAA process and mandate development across asset classes is finalised, the process of portfolio construction and investment selection comes into focus. This process can be executed by an in-house team or by an external manager, each of which present different considerations for the responsible investor.

IN-HOUSE: PORTFOLIO CONSTRUCTION AND INVESTMENT SELECTION

The PRI has developed guidance across asset classes on how portfolio managers can manage assets in-house, working through the kinds of considerations described in the mandate development section above.

- Listed equity
- Hedge funds
- Fixed income
- Infrastructure
- Private equity
- Real estate

EXTERNAL: SELECTION, APPOINTMENT AND MONITORING

If outsourcing portfolio construction and investment decisions to external managers, an asset owner will usually feature the ESG/sustainability requirements developed in their mandates in their Request for Proposals (RfP).

In the selection process, it is important to distinguish between manager selection and fund selection: managers with a clear ESG policy may still have funds that do not take ESG factors into account, while managers that do not have overall ESG policies may have specific funds that meet the asset owner's requirements. Some investment managers can provide customised solutions that meet the RfP requirements.

An asset owner must not only look at policies, but equally factors affecting implementation, such as staff expertise, organisational culture and reporting frequency. This usually requires a due diligence process to assess how formal manager statements work in practice.

- Enhancing manager selection with ESG insight
- Responsible investment due diligence questionnaires (DDQs)
- Considering ESG integration in listed equity manager selection

Once a manager has been selected, the next step might be to incorporate the agreed ESG/sustainability requirements during the appointment process. This could be in the fund documentation of the Investment Management Agreement (IMA), or in the Limited Partnership Agreement (LPA) or a side letter. This contributes to creating a robust governance structure for incorporating ESG considerations into all stages of the investment process.

- Considering ESG integration in listed equity manager appointment
- Incorporating responsible investment requirements into private equity fund terms

Finally, asset owners (and their fiduciary managers) should consider having a system that allows them to monitor the selected investment managers. This requires regular reporting by the asset manager. It may also require arrangements to be made about how an asset owner will be regularly informed, either in written documentation or in-person meetings. Arrangements to address this could be incorporated in the IMA or the fund terms.

- Monitoring listed equity managers' ESG integration
- ESG monitoring, reporting and dialogue in private equity

7. ACTIVE OWNERSHIP (VOTING, ENGAGEMENT AND LITIGATION)

Although active ownership itself is a post-investment activity, asset owners should incorporate their active ownership requirements throughout the process described above. (Read more in the *Responsible investment methodologies* section.)

- A practical guide to active ownership in listed equity
- ESG engagement for fixed income investors
- Selection of issue-specific engagement guides

RESPONSIBLE INVESTMENT METHODOLOGIES

Responsible investment is a broad concept. There are no fixed rules about how an investor must include ESG factors in investment decision-making, and the PRI does not have or promote a preferred methodology.

The PRI broadly groups the variety of approaches available into ESG incorporation (comprising integration, screening and thematic investment) and active ownership. Alongside these sit options to act outside of the portfolio to influence the markets in which investors operate, such by engaging public policy makers.

It is up to individual asset owners to interpret their fiduciary duty and choose which methodology (or combination of methodologies) best fits their objectives.

Responsible investment methodologies to consider include:

- norms-based screening
- negative screening
- positive or best-in-class screening
- fundamental integration
- factor investing
- ESG tilts
- thematic investing
- impact investing
- responsible investment in passive or ruled-based investing
- three-dimensional investing
- active ownership (voting, engagement, litigation)
- public policy engagement

NORMS-BASED SCREENING

Norms-based screening screens investments against minimum standards of business practice based on international norms. Useful frameworks include UN treaties, Security Council sanctions, UN Global Compact, UN Human Rights Declaration, OECD guidelines.

NEGATIVE SCREENING

Negative screening excludes certain sectors, companies or practices from a fund or portfolio based on specific ESG criteria. It involves identifying companies that score low on ESG issues, are involved in the production of certain products or services (e.g. controversial weapons, tobacco, alcohol, gambling) or associated with certain business practices (e.g. genetic modification, human rights violations or child labour).

Involvement in products/services is often determined by percentage of revenue, e.g. screening out fossil fuels could mean screening out companies that generate more than 15% of their revenue from fossil fuels. The percentage used is typically between 5% and 50%, and can be applied at the sector, issuer or security level. ESG scores, e.g. for excluding the worst 5%-50% of companies on a particular issue, can be obtained from specialist ESG service providers, or by creating a proprietary scoring methodology using ESG data sources.

POSITIVE OR BEST-IN-CLASS SCREENING

Positive screening involves investment in sectors, companies or projects selected for positive ESG performance relative to industry peers. This typically ranges from the best 50% to 10%, or even 5% depending on the level of portfolio concentration an asset owner is comfortable with. If conducted per sector, this is also known as best-in-class screening.

ESG screening in fixed income investing

FUNDAMENTAL INTEGRATION

While the aforementioned methodologies limit the size of a portfolio based on ESG criteria, fundamental integration aims to identify and quantify the effect of ESG issues on individual companies, and to integrate that into company valuation and therefore the investment decision process. This rests on identifying the extent to which ESG issues (both risks and opportunities) affect expected future financial returns and therefore share prices. For example, a company that uses a lot of water in the production process may face supply risks due to growing water scarcity, raising the possibility of additional investments, or relocation of production.

ESG integration in fundamental strategies

FACTOR INVESTING

Fundamental integration is typically used in active portfolio management, however factor investing can provide a rule-based approach to ESG integration, thus enabling a form of integration to be used in passive strategies. Material ESG issues are identified, and then translated into rules that feed into portfolio construction – alongside traditional factors.

ESG integration in quantitative strategies

ESG integration in smart beta strategies

ESG TILTS

As well as being used to determine whether a company or fund should be included in the portfolio, ESG scores can be used to diversify within the portfolio, giving a higher weighting to companies or funds with a good ESG score and a lower weighting to those with a low ESG score. The process of over and underweighting is called tilting. The percentage of over and underweighting will vary depending on an asset owner's preferences.

THEMATIC INVESTING

Thematic investing identifies economic activities that combine attractive risk-return profiles with an intention to contribute to specific sustainability outcomes, and seeks to invest in companies or other investable entities that provide these types of products and services. Examples include clean technology, renewable energy, green property, sustainable forestry or farmland, affordable housing, micro-finance and access to education, health, clean water or sanitation.

Themed fixed income investment

IMPACT INVESTING

Impact investing is a subset of thematic investing, but with additional requirements. Like thematic investing, impact investing intends to contribute to sustainability, but seeks to make sure that the investments lead to additionality of the sustainable impact. Additionality means that the sustainable outcome would not have been achieved without the investment. It also requires adequate measuring and monitoring of the investment's sustainability performance.

Impact investing market map

RESPONSIBLE INVESTMENT IN PASSIVE OR RULE-BASED INVESTING

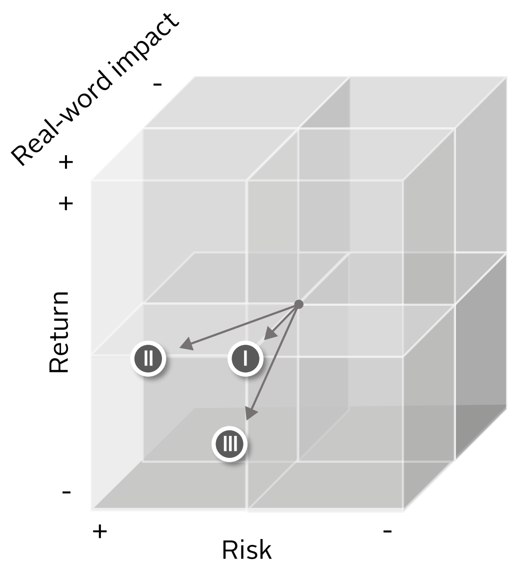
Although a passive investment strategy is often understood as a capitalisation-weighted index, passive investment is fundamentally rule-based and market cap weighting is just one of the rules that can be used to create a passive portfolio. All of the above-mentioned methodologies can be used in constructing a rule-based, passive portfolio that is aligned with responsible investment.

ESG integration in passive strategies

THREE-DIMENSIONAL INVESTING

As mentioned above when discussing investment strategy, the PRI has expanded on the two-dimensional concept of risk and return by outlining a third dimension of real-world impact. The underlying idea is that with the same risk-return profile, an asset owner can create a portfolio at different positions on the third axes of real-world impact. Alternatively, the third axis can be used to balance real-world impact outcomes against risk and return performance, in cases where an asset owner is willing to accept a different risk-return profile in exchange for greater real-world impact. The UN Sustainable Development Goals (SDGs), launched in 2015, are the widely accepted global framework for considering positive real-world impact.

Figure 3: Investors that would consider real-world impact a primary objective would choose to prioritise it even at the potential expense of risk and return.



ACTIVE OWNERSHIP (VOTING, ENGAGEMENT AND LITIGATION)

Active ownership is the use of the rights and position of ownership to influence the activity or behaviour of investees. This can be applied differently in each asset class. Shareholder rights include voting rights, individual or collaborative engagement and (if necessary) litigation. ESG issues can be incorporated into voting policies and voting decisions. Engagement can occur individually and/or collaboratively to encourage companies (and other invested entities) to improve their ESG performance or sustainability.

(Investors also sometimes use the word engagement to refer to pre-investment activity, such as when an investor speaks with a company to better understand it, including how it performs on ESG-related matters. Strictly speaking, that is not an ownership activity and is generally aimed at learning about the company rather than influencing it, so does not qualify as responsible active ownership.)

Litigation is a last resort to recover financial damages, and potentially to initiate future improvements, after major incidents – including those related to ESG matters – have occurred.

If an asset owner manages its assets in-house or has segregated accounts with its investment managers, it can exercise these shareholder rights itself or ask the investment manager or a service provider to do so on its behalf. If it invests through external managers and funds, it can incorporate its expectations during manager selection, appointment and monitoring.

While traditionally confined to listed equity, asset owners and investment managers are increasingly adopting active ownership practices in other asset classes including corporate bonds, private equity and real assets such as property and infrastructure.

A practical guide to active ownership in listed equity

Selection of issue-specific engagement guides

ESG engagement for fixed income investors

PUBLIC POLICY ENGAGEMENT

For investors to fully pursue responsible investing, they need the global financial system that they operate in to be sustainable, but financial and regulatory incentives in economic and financial markets are not always conducive to responsible investment. Investors can engage – individually, collaboratively or through the PRI – with governments and regulators to create an economic/financial system that is robust, and that incentivises responsible, sustainable businesses and investments.

The case for investor engagement in public policy

OTHER CONSIDERATIONS

There are many other financial methodologies or instruments (particularly in hedge funds) that are not specifically related to sustainability topics, but which have ESG or sustainability implications. Examples include short-selling, derivatives, securitisation, securities lending, leverage, synthetic products and collateral. Large-scale securities lending, for instance, may conflict with the objective of being a responsible, active owner.

Some of these approaches can incorporate ESG issues more readily than others. The PRI is yet to explore in detail if and how they can best fit into a responsible investment approach, but asset owners will need to make decisions on the use of these strategies and instruments.

There are similar considerations for ownership strategies an investor might employ. For instance, there is nothing irresponsible about a strategy that takes a long position on company X and short on company Y based on fundamental considerations that include material ESG issues; but, short selling a company and making negative statements to depress its share price is a form of aggressive activism that would not typically be seen as a part of responsible investment.

REPORTING AND ASSESSMENT

Transparency throughout the investment chain is key; just as it is important that companies and other invested entities report on their management of environmental, social and governance issues in their operations, investors must monitor and report on their responsible investment activities.

PRI signatories do this through PRI reporting, the largest global reporting project on responsible investment. Signatories are required to report on their responsible investment activities annually, which ensures:

- accountability of the PRI and its signatories;
- a standardised transparency tool for signatories' reporting;
- that signatories receive feedback from which to learn and develop.

Equally as important, reporting by asset managers and service providers under the PRI Reporting Framework creates a valuable pool of information for asset owners. For example, asset owners can use the PRI Data Portal to compare responsible investment credentials when selecting managers.

Learn more about PRI reporting

SUPPORT FROM THE PRI

Although this paper outlines the basics of responsible investment, an asset owner that has just embarked on this journey may need additional guidance on how to implement responsible investment across its strategy, organisation and investment practices.

The PRI has produced numerous guidance documents and tools to help asset owners on various aspects of responsible investment, and will continue to do so in line with market trends and developments.

Keep up to date with all the latest resources available from the PRI at www.unpri.org.

If you would like more information on responsible investment, including how to become a signatory, please contact us.

Get in touch

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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

PRI Principles for Responsible Investment

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

UNEP FINANCE INITIATIVE

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

United Nations Global Compact