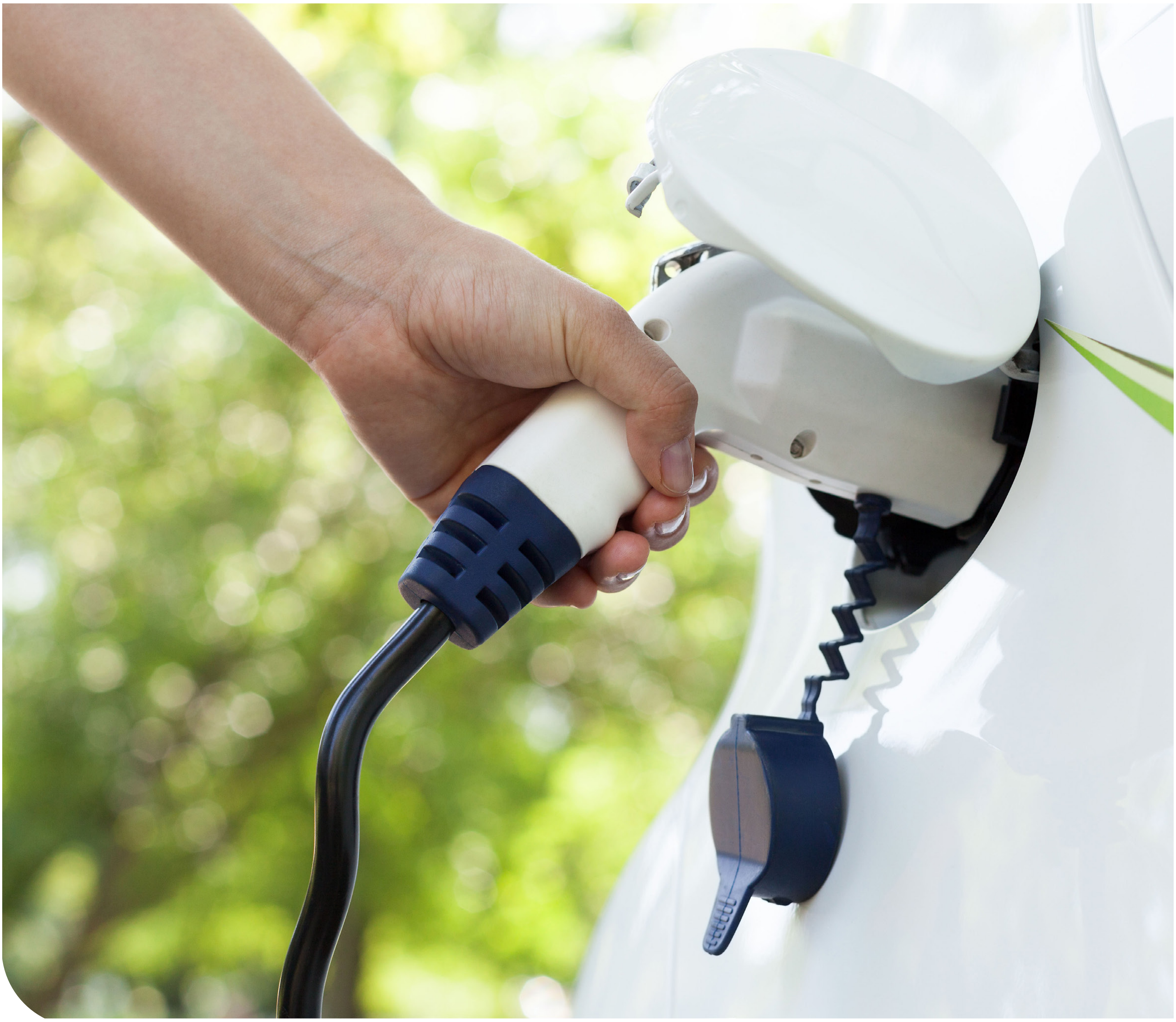
Responsible Investing

Frequently asked questions

2019



DISCIPLINED BY NATURE. FLEXIBLE BY DESIGN.
The icons alongside represent our investment process. Through a disciplined provision of investment policy and security selection at the global level, regional portfolio management teams have the flexiblility to construct portfolios to meet the specific requirements of our clients.

HIGHLIGHTED IN THIS PUBLICATION:

GLOBAL STRATEGIC ASSET ALLOCATION

GLOBAL SECURITY SELECTION

REGIONAL ASSET ALLOCATION

REGIONAL PORTFOLIO CONSTRUCTION

The ESG considerations contained in this document can change without notice.

Approach and philosophy

1) Why should we integrate ESG data into our analysis?

There are different reasons for integrating ESG factors. What links them is that they provide additional information rather than an alternative assessment. More specifically it:

- widens the lens used to analyse companies and takes a longer time-horizon (which is a necessary requirement of assessing ESG issues). This provides a better understanding of the issues companies face.
- helps anticipate downside risks to long term performance. For example, ESG integration might help mitigate risks related to company reputation, in a context where intangibles now represent more than 80% of the average S&P500 firm's book value.
- helps identify well-managed companies based on ESG credentials.
- recognises that long-term institutional and pension fund investors increasingly demand ESG integration.
- turns the focus towards long-term performance.
- can help anticipate future regulation.
- meets growing client interest in sustainability.
- can have an impact on corporate behaviour. This can occur, for example, through shareholder advocacy, or through directing capital to undercapitalized but high impact sectors.
- recognises the "Universal Ownership Principle" (see below) that institutional investors with a large, diversified portfolio are exposed to broad ESG risks.

2) Can ESG be defined as ethical investing?

There is some overlap between ESG and ethical investing but the two are not equivalent. Ethical investing is an approach that generally excludes investment in certain activities or industries seen to be unethical (such as alcohol, armaments, gambling and tobacco). The ethical principles used for such exclusion are often based on cultural background. An important branch of responsible investing uses similar exclusion principles – not investing in certain companies or sectors – but these are not necessarily based on ethical grounds. For example, it may be that coal companies are excluded from an ESG investment strategy on environmental grounds whereas they may not be deemed 'unethical'. Furthermore, some ethical, activist investors may seek investment in 'unethical' stocks in order to bring about change in a company's policy.[1]

3) Does ESG limit the investment universe?

Applying ESG considerations can reduce the investment universe because it can lead to certain companies being excluded. Within EFGAM, only a limited number and type of companies are excluded, so there is an extremely limited impact on the investment universe.

4) Does ESG integration create inefficiencies and a skewness towards certain sectors?

In EFGAM, our ESG ratings are relative: the emphasis is on finding the best companies within any sector/area rather than excluding sectors in total. Therefore, any skewness towards certain sectors is avoided.

5) What is the "Universal Owner" principle?

The Universal Owner principle states that a large institutional holder of a diversified portfolio can be seen as having an exposure to the entire economy and financial market. For such as diversified investor "there is no place to hide". If one company externalises its costs in the form of, for example, environmental damage and poor labour practices, these affect other companies in the portfolio and the entire economy. Its actions may result in higher taxes, new legislation, higher insurance premiums, inflated input prices and the physical and social cost of disasters. There are three avenues that Universal Owners may take to manage the risks associated with such externalities: active ownership, seeking to influence public policy and using an investment strategy incorporating ESG considerations.

[1] As was seen, for example, when a motion put forward by a group of Seattle nuns, who were shareholders in an American gun company, forced it to monitor the use of its guns in violent crime and the measures it was using to make its guns safer.
See https://www.theguardian.com/us-news/2018/sep/25/smith-and-wesson-gun-safety-nuns-accountability

6) How to differentiate from competitors?

We are putting in place a well-defined process that starts from our (existing) fully transparent and flexible proprietary rating system and integrates its findings in a comprehensive assessment of the companies in which we invest. Our rating system is the starting point for engagement and voting activities. Many of our competitors buy a standardized rating score and set the focus on only the companies with the very highest ESG ratings. We think this approach can be unnecessarily restrictive. Our rating system is the starting point for engagement and voting activities.

Analysis, regulation and standards

7) What is/will be the role of regulation?

Regulation is likely to play an increasingly important role in ESG investing. It may speed up the integration of ESG considerations. In particular the pricing of externalities (such as pollution, CO2 emissions and respect for human rights) needs to be regulated at a high level with clear and long-term plans. Regulators around the globe are already pushing for increased adoption of ESG standards and they are included in listing requirements for many exchanges. Although we expect the role of regulation to become more important, this does not remove the “personal” responsibility of corporations to act in a responsible and sustainable way.

8) How should we define our standards and norms for ESG investing? Will new standards make our current system obsolete?

Our ESG rating system is fully transparent and flexible to modifications and inputs. It represents our view and can be collectively modified, adapted and improved. Standards will emerge relative to how companies have to report, not in how investors have to use these data. Some standards will probably emerge with respect to client transparency.

9) Why do ESG ratings issued by different rating agencies diverge? Why is there little consensus?

There are three main reasons for the differences. First, different rating agencies use different indicators. Second, they use different processes for aggregation of those indicators (for example, providing different weights to the three broad environmental, social and governance factors and the weights of different measures within those three categories). Third, there is an element of measurement error, especially because ESG factors are assessed on a scale (from best to worst).

10) Given that rating agencies’ outcomes are modestly correlated, why should we take all the effort which is needed to integrate them? When will we have a better correlation among their scores?

Even though ESG ratings are not perfect and are modestly correlated with each other, it is important to make the effort to include, rather than ignore, these factors. ESG ratings are a complementary viewpoint, from which a better understanding of a firm’s risks can be obtained. The correlation among rating agencies will probably improve when reporting standards become compulsory and when the industry develops towards a more commonly-agreed method for assessing and grading risks. At EFGAM, we use a reputable ESG raw data provider to calculate our own score, and we reserve the ability to consider further options, as the market evolves.

11) What is the role of investors with respect to data quality and transparency? Investors clearly would like such information to be as reliable, comprehensive and clear as possible.

Transparency and data quality remain an issue in the ESG space since reporting is still at an early stage and is not fully comparable across regions/countries. A few global or specific standards such as SASB (Sustainability Accounting Standards Board), GRI (Global Reporting Initiative), IR (integrated Reporting) and CDP (Carbon Disclosure Project) are acting as a reference but they are not yet mandatory. Companies are thus reporting data using different approaches. These differences are compounded when ESG rating agencies employ divergent data sets and methodologies to compose their aggregate ESG scores. The good news is that the combined efforts of investors asking for more transparency and tighter official rules are slowly improving the quality of ESG reports.

12) How do you deal with small caps and companies that fail to provide adequate data?

This is a difficulty. Although small cap companies may not provide full ESG data, we think this should not itself preclude them from being included in our investments. In such cases we can look at other sources of information -

such as the reputation a small company has in terms of its corporate governance – as an indicator of its attitude to behaving responsibly.

Financial consideration

13) Does ESG integration provide alpha or beta exposure? What is the financial performance of ESG-rated companies?

The alpha of ESG is a difficult call and academic literature is not unanimous. On average roughly 90% of studies find a non-negative relationship between ESG and corporate financial performance (measured in a variety of different ways).[2] There is a broad consensus that ESG performing companies tend to enhance the Sharpe ratio (the ratio of excess return to risk) particularly because they show slightly lower volatility. This can be explained by the proactive feature of the ESG integration approach against key risks, coupled with the positive correlation between big size and ESG.

14) Is ESG a thematic play?

Not necessarily. ESG ratings are the outcome of an overall assessment of a company, while a thematic approach focuses mainly on its products/activities. At EFGAM, we adopt a holistic approach, taking into account ESG alongside more traditional financial considerations, in coming to an overall assessment.

15) Can ESG performance be an indicator of corporate management's quality?

Much academic research has shown a positive correlation between financial metrics and ESG data. It is possible that these correlations are a result of mutual correlation to an unobserved variable like "management quality." This is also a question of common sense: who thinks that companies that do not manage resources or CO_2 emissions effectively, that lack motivated, well skilled and trained workforce or with bad corporate governance can be defined as well managed firms?

16) How can ESG be integrated in the fund selection and in the analysis of third-party funds?

This is a complex process. Currently there are some companies that provide ESG fund ratings. However, their approach screens the underlying securities in those funds and pays no attention to funds' investment process. The results are therefore biased by the ESG rating agency used. At EFGAM, we think the best way to assess third party funds is to focus on the processes used to integrate the ESG ratings. While this approach is more complex, we think it is more robust.

17) Walk the talk, how is EFG International Group performing?

EFGAM Responsible Investing reflects EFG International Group's philosophy: together, we are at the beginning of an interesting journey – more is to come.

18) Is it possible to integrate ESG data transversally, without silos?

This is what we are working toward: the RMS tool we use helps us move in this direction. Ratings and information are already built in, and more data will collectively be inserted. ESG data are on a company level and can therefore be used by equity or fixed income investors even if the approach needs to be somehow differentiated between the two asset classes.

19) What are the best practices within the ESG space?

The PRI has conducted a solid review in this area. They highlight a multitude of different approaches with some common aspects. Best practices should contain:

- Policies
- Objectives
- Monitoring, measuring and reporting of ESG ratings
- Engagement
- Voting processes

[2] Friede, Busch & Bassen ESG and financial performance: aggregated evidence from more than 2000 studies Journal of Sustainable Finance & Investment, 2015. http://dx.doi.org/10.1080/20430795.2015.1118917

- Products
- Staff training
- Client engagement

20) How is it best to allocate time between financial analysis and ESG analysis?

Within the next decade we think ESG will become part of the normal due diligence that will be required by investors and we do not see it in opposition, but as a complement, to standard financial analyses. We acknowledge however that at the beginning it can be complex to integrate ESG into financial analysis. For this reason, we have issued our proprietary ESG ratings and are working to a set of questions, tailored to the industry, that we can ask of companies to better understand their sustainability profile.

21) How can an ESG integration approach be used to assess countries?

We developed a rating system also for countries. Similar to the corporate one, it contains data on governance, social and environmental aspects. This information can be used to inform decisions about in-country equities as well as public debt issuances.

22) How does an ESG engagement work with fixed income investments?

We acknowledge that engagement is more difficult within the fixed income space as voting is precluded. However, a few options still exist:

a. Collaborative engagement with other asset managers.

b. When engaging with a company both equity and fixed income assets under management can be added up to increase bargaining power.

c. Pressure can be placed on book-runners to raise the level of required level of ESG disclosure.

23) How should green bonds be treated?

We see green bonds as more of a thematic/impact investment. Their regulation is still far from perfect and is now mainly disciplined by the voluntary Green Bond Principles of the International Capital Market Association (updated guidelines were published in June 2018). The principles cover four main areas:

- Use of Proceeds
- Process for Project Evaluation and Selection
- Management of Proceeds
- Reporting

We expect more clarity on the topic in the near future as the European Commission announced the creation of a technical expert group to report on an EU green bond standard soon.

Clients

24) Is ESG something that is aimed at institutional clients only?

ESG started as a tool used mainly by institutional clients, but retail clients are now closing the gap, everywhere and at a fast pace.

25) How will all this be translated to clients?

We are working on a taxonomy that should help clients understand the different goals and objectives of our investment choices.

There may be occasions in which a fund's shares may not be voted in strict adherence to these Guidelines. These decisions will always be based on our review of the merits of the proposal and will consider relevant information and company-specific circumstances.

Our policy is subject to change without notice

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