

ACHIEVING INVESTMENT OBJECTIVES THROUGH ESG INTEGRATION

novethic

A PART OF CAISSE DES DÉPÔTS ■

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Purpose of the study

From SRI to ESG integration: crossover, scope and game rules

New practices have developed alongside the clearly identified market of SRI (Socially Responsible Investment) that we will hereinafter refer to as *ESG integration*. ESG integration involves taking Environmental, Social and Governance issues into account in traditional financial management. At first, these practices may seem to represent some sort of accomplishment for SRI, graduating it from its niche status to the financial management market as a whole.

Some investment managers have recently begun to emphasise this approach in their communication, applying it more or less systematically to all assets under management. Today, this represents at least EUR 2,460 billion in assets in France¹. An amount not to be taken lightly, considering that Novethic estimated the assets under management concerned by ESG integration at EUR 66 billion at the end of 2008.

That said, the extra-financial requirements imposed on the assets subject to ESG integration are not as strict as those imposed on SRI funds, and practices can vary widely from one manager to another.

This brings about a new debate about how the SRI market is accounted for (*see box below*) and how financial actors actually incorporate ESG issues into their management strategies. Although only a few players, such as ERAFP², can viably claim 100% SRI management, an increasing number of investors boast the application of ESG criteria to all of their financial assets.

SRI in figures

Every year, Novethic conducts a survey of all actors involved to measure trends in the French SRI market. On a European scale, the professional organisation Eurosif releases a study every two years based on market data from European countries active in SRI. In recent years, ESG integration practices have begun to emerge in these studies. This raises the issue of what ESG integration entails exactly and what differentiates it from SRI.

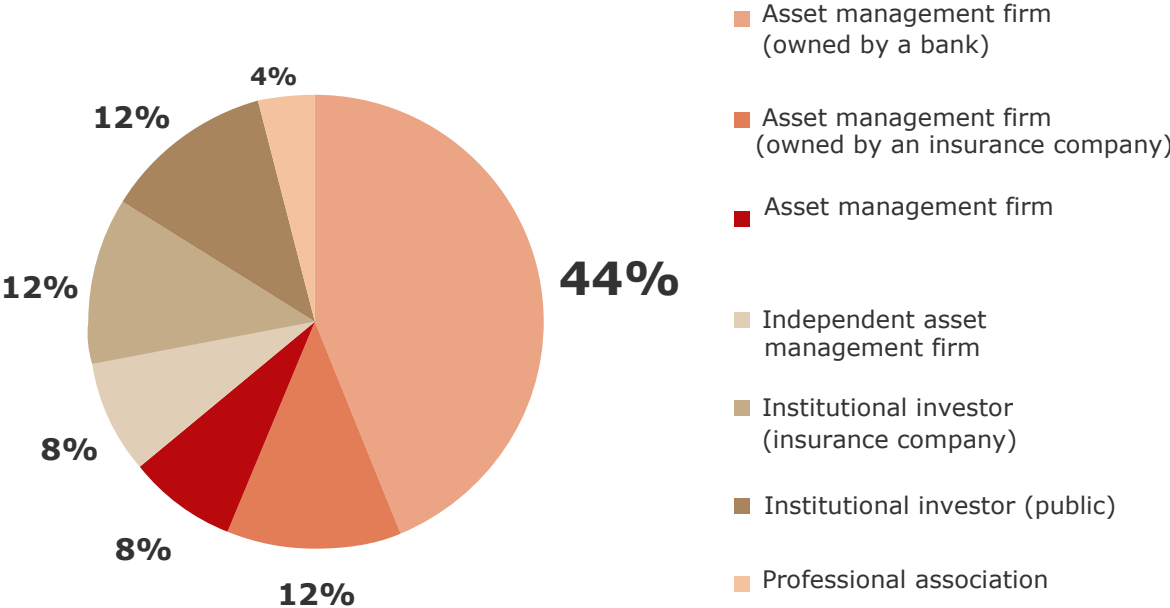
Against this backdrop, Novethic's research centre took an inventory of current ESG integration practices in this rapidly changing sector. The purpose of this paper is to distinguish them from socially responsible investment practices and classify them into different categories as much as possible.

Between December 2009 and February 2010, Novethic interviewed about thirty investment managers or asset owners (institutional investors)³ based on the ESG integration practices identified in France in SRI literature and studies.

¹ This figure represents total assets under management declared by those surveyed as covered by at least one ESG integration practice described in this study.

² *Établissement de Retraite Additionnelle de la Fonction Publique*, French Public Service Additional Pension Scheme.

³ See appended list.



Breakdown of respondents

I. ESG integration

Definition and terminology

Over the last decade, sustainable development and critical issues such as climate change or corporate governance have become an integral part of the financial world. Investors developed niches by setting up SRI (Socially Responsible Investment) funds while streamlining their analysis of these extra-financial issues. These clearly identified SRI funds met the expectations of asset owners looking to reduce their exposure to controversial investments.

More recently, mainstream asset managers joined in, taking an "à la carte" approach to applying Environmental, Social and Governance (ESG) criteria compared with SRI funds. These practices are referred to as *ESG integration*⁴ or *mainstreaming*.

These approaches are spreading but the concepts behind them remain elusive. We will first differentiate ESG integration from SRI before describing the concrete practices. Unlike SRI, which involves systematic incorporation of multiple ESG criteria in investment decisions, ESG integration is applied on a case-by-case basis. Most often, it only covers the extra-financial issues considered to have a direct impact on medium- to long-term company performance.

PRI leading by example

In 2006, the Principles for Responsible Investment or PRI were introduced, under the auspices of the United Nations, by investors vying for the increased penetration of ESG issues in financial markets. The PRI are broken down into six principles. The first is an explicit commitment: "We will incorporate ESG issues into investment analysis and decision-making processes." As such, PRI compliance has become a benchmark that encourages the establishment of ESG approaches.

This voluntary commitment to PRI requires signatories to report on their progress in integrating ESG issues on a yearly basis. Practices can then be compared with each other.

The PRI represent an international standard and become a vector for ESG integration practices.

Since 2006, a large number of investment managers and professional service partners have joined the ESG arena, which used to be comprised of asset owners only.

The 703 signatories today (46 of which are French) are broken down into 199 asset owners (4 in France), 368 investment managers (35 in France) and 136 professional service partners (7 in France), which together weigh in at USD 18 trillion in assets.

The PRI have also opened up ESG integration to new asset management businesses. Dedicated working groups have been set up to look into applications in property investment, private equity, or investing in emerging countries.

The distinction between SRI and ESG integration can be verified based on PRI reporting. The 2009 PRI Report on Progress noted that 22% of the investment managers that

⁴ This term was more frequently used by survey respondents and will therefore be used hereinafter.

responded stated they were "SRI managers" while 78% claimed to be mainstream managers. SRI managers' ESG integration scores were, on average, significantly higher, mainly due to two factors:

- SRI predates ESG integration.
- SRI managers methodically integrate ESG issues into their investment processes, while mainstream managers tend to combine several investment objectives, therefore blurring the line between ESG and traditional financial criteria.

History and international reach of ESG integration

ESG approaches are relatively recent for most respondents. The precursors in France (Groupama Asset Management, Prado Épargne Gestion) set up their initial concrete approaches as early as 2003. However, in 2008, the FRR (French Pensions Reserve Fund) set the standard with its new strategy, which has been adopted by both asset owners and investment managers. Only a fifth of the respondents of our survey had established an ESG approach before 2006, while over half have done so since 2008.

PRI reporting ⁵ shows that ESG integration has crossed over western borders, with 40 signatories in Brazil and 30 in South Africa. It also shows that:

- The best performers include Canada, with 40 signatories delivering high scores, the United Kingdom (82), Switzerland (36) and France (44).
- Asset owner signatories turned in higher scores than investment managers in the United Kingdom, Netherlands and in Scandinavia.

⁵ The PRI Report on Progress, published every year, summarises signatories' assessment process. Here we refer to the 2009 report.

II.

ESG integration tools

To better understand ESG integration practices, we have examined the driving force behind them.

Make extra-financial screening profitable...

SRI funds - which represent only a minor portion of assets under management⁶ require considerable resources: analyses purchased from rating agencies, in-house recruitment of specialised extra-financial analysis teams, etc. The development of specialised screening has shown that certain key extra-financial issues (pertaining to the sector, economy, geography) play an important economic role. As such, ESG integration clearly meets two of the primary goals of portfolio management companies:

- "Recoup" investments made to establish SRI management.
- Meet changing fiduciary duties: identify "material" ESG criteria⁷ and assess a given investment's exposure to them. The Freshfields Report, released in 2005 for UNEP-FI and updated in 2009 as *Fiduciary II*, pointed out that in many countries, managers who fail to raise and take into account ESG considerations could be sued by their clients for negligence regarding factors that affect the long-term valuation of their assets.

This more specifically concerns bond management, in which ESG issues are increasingly regarded as risk factors to be integrated directly into company valuations.

More ethical concerns, however, tend to be willingly left to SRI funds to deal with.

Although some asset owners, notably insurers for which long-term risk management is critical, can be directly impacted by material ESG issues, the real reasons why they integrate ESG criteria are often entirely different.

... or protect one's reputation

For most asset owners, ESG integration offers a means to align financial management practices with parent company values. They are generally seeking to protect themselves against reputational risk and the threat of controversy that could tarnish their brand image. Joint, collective or public institutions, which often tout their social responsibility values in their communication, consider this to be a very real risk. The subject is rarely mentioned in the French media, while pension funds' investment choices make headlines in many Scandinavian countries. In France, campaigns by NGOs such as Friends of the Earth or Amnesty International specifically target finance companies, banks and insurers, fuelling the notion that these professions are no less exposed to controversy than industrial multi-nationals.

⁶ French SRI funds account for 2.39% of total assets under management. Source: *Novethic 2009 SRI Indicator*, January 2010.

⁷ The materiality of an ESG issue refers to its expected impact on the economic, financial or stock market behaviour of a given securities issuer (company, government, etc.).

Commercial issue

Both asset owners and investment managers agree that ESG integration has become an important issue in their commercial relations, making their motivations all the more striking. The majority of investment managers surveyed noted that almost all management bids in the past two years have requested clarifications as to their ESG integration practices. As a result, the sales staff, the teams who answer bids and, more importantly, the management are all turning to fund managers to meet this demand, even in companies where SRI had not been established.

As yet, most bids from asset owners do not require an ESG integration approach, even less a structured SRI approach, but they inquire about managers' ability to assess extra-financial issues. It is this very ambiguity that explains the difference between investors and managers' attitudes and the wide range of practices.

The financial crisis: an additional driving force

Another argument in favour of ESG integration given by some managers is a direct result of the financial crisis. Since the turmoil began in 2007, some clients and investment managers have accepted the idea of more moderate gains in the short term in favour of a more long-term approach. Groupama AM believes that the client has to accept the loss of a few basis points in the very short term caused by an ESG approach to money market investments. This is notably due to excluding certain complex instruments, but it means reducing the risk of issuer default.

There is a growing number and variety of reasons to integrate ESG issues into investment decisions. Surprisingly, the promotion of sustainable development is almost never mentioned. When it is, it is more for reasons of shareholder engagement or investment in sustainable development areas. These parallel practices are not really included in what is considered to be ESG integration.

III.

Tangible results of ESG integration

The concept of ESG integration is not standardised and can cover diverse practices. We will examine the concrete characteristics to determine their advantages and limitations. ESG integration practices have been broken down into two major categories:

- Reputational risk management.
- Combination of ESG criteria with traditional financial analysis.

Ethical investment versus ESG integration

Norm-based screening used for reputational risk management

A norm-based approach in SRI fund management aims to identify companies or governments guilty of evidenced, recurrent violation of a fundamental human right (according to the International Labour Organization's Declaration on Fundamental Principles and Rights at Work concerning forced labour, child labour, discrimination and freedom of association), or an environmental or governance standard. Identified issuers are generally excluded. For managers, this offers the advantage of only slightly limiting investment universes and stock-picking opportunities⁸. The screening approach aims to optimise investments based on their extra-financial risk/return characteristics, but this remains difficult to determine. In contrast, the norm-based approach only seeks to protect against reputational risk. Reputation is a growing concern for asset owners, especially banks and insurance companies. NGOs request more detailed information on the financing of major projects or in the weapons industry, hence the use of this type of norm-based approach by an increasing number of investment managers. Internal or external alert systems can be used that cover particularly broad investment universes at a reasonable cost, enabling them to meet institutional investors' expectations without too many additional constraints.

To date, Novethic has listed 4 French firms that use this approach, and 5 others planning to do so in 2010, which is eventually expected to total EUR 970 billion in assets, as against EUR 110 billion at the beginning of 2010.

Allianz Global Investors France is one of the first asset managers to implement a norm-based system. Human rights have been a determining factor for all equity portfolios since 2005. Twenty-seven shares have been excluded from the MSCI EMU, representing 9% of the total number of securities eligible for investment.

The FRR (French Pensions Reserve Fund) has been using the Convention Watch service offered by the UK agency EIRiS since 2009 to assess all of its funds under delegated management (company shares) against international norms. This assessment is designed to guide the FRR in its dialogue with issuers and may, as a last resort, lead to divestment. For the most part, MAIF directly manages government bonds. The French

⁸ Stock-picking is both an investment style and philosophy. It is a technique used to select investments based only on company characteristics rather than the stock market or asset allocation strategies. It is the opposite of index-based management which merely aims to track index or market performance.

insurer uses ILO standards, the Kyoto Protocol and the UN's Millennium Project goals as a basis for this norm-based screening, which was implemented in 2009.

Amundi, the result of the merger between Crédit Agricole AM and Société Générale AM, already uses a norm-based approach for SRI funds and plans to extend it to mainstream management. Société Générale Gestion (formerly SGAM) plans to follow suit. The merger of these two entities within Amundi is expected to open the floodgates for norm-based exclusion, as the new group alone manages assets worth 20 times those of the French SRI market!

Some foreign asset owners are particularly fond of this method, judging from approaches used by the Norwegian sovereign fund and a number of Nordic pension funds.

Second wind for sector-based exclusions

First used for ethical funds, sector-based exclusion is the traditional SRI approach and is now being applied to ESG integration and mainstream management. Initially excluded for moral reasons, the tobacco, alcohol and weapons sectors are only rarely taken as a whole. Except for MAIF, which is the only investor to have excluded the weapons sector, sub-sectors considered to be involved in specific controversy are more often targeted today, namely:

- Production of fossil fuels, GMOs and bulk chemicals by Financière de Champlain, specialised in thematic investment (environment, healthcare).
- Food speculation by CNP Assurances, more in alternative investment (commodities) than traditional equities management, which is currently working on exclusion criteria concerning the crucial ESG issues in each sector.
- Production of palm oil, currently under review by an investment manager after an environmental NGO issued a request to its parent company.

Controversial weapons: anti-personal mines and cluster bombs

At the crossroads between norm-based and sector-based exclusion is the production and sale of anti-personal mines or cluster bombs.

In 1997, the **Ottawa Convention** was the result of international negotiations to prohibit the use, stockpiling, production and transfer of anti-personal mines. It has since been ratified by 154 countries, including European Union Member States (except Poland, which signed the treaty but did not ratify it). The United States has not signed it. Ten years later, the **Oslo Process** aiming to prohibit and eliminate cluster bombs was signed by 104 countries and ratified by 30, including European Union Member States. The United States is still absent from the list. With the required number of signatories and "State parties"⁹, it will enter into force on 1 August 2010.

These treaties concern specific weapons considered particularly intolerable because of their devastating effects on civilian populations even after the end of a conflict. This prompted NGOs, first in Belgium then in other European countries, to initiate campaigns specifically targeted against investors likely to finance these industries. As a result, companies like Axa have defined policies against investment in these companies. Dexia has even decided to exclude, in addition to anti-personal mines or cluster bombs, any company involved in the depleted uranium weapons industry. These campaigns were covered by the press, leading Belgium, one of the first signatories of the Ottawa and Oslo treaties, to prohibit investment in these sectors by financial companies operating in the country. In the Netherlands, the television show Zembra TV condemned large pension funds investing in companies that manufacture anti-personal mines or cluster bombs. The controversy drove these funds to review their investment policies and comply with these international treaties signed by the Netherlands.

Today, five asset owners and eight investment managers surveyed by Novethic, representing over EUR 2.2 trillion in assets, claim to exclude companies that violate these treaties from all of their funds (except for management mandates, unless upon specific client request, and index-based investment). Regarding index-based investment, some suggest that the NGOs that instigated these campaigns should also put pressure on the financial indices themselves. This would in turn impact a large number of funds and provide a considerable incentive to implement an exclusion strategy.

The investors concerned are not very transparent about sector-based exclusion policies and the list of incriminated issuers. Banque Postale Asset Management stands out with its detailed approach and the list of companies excluded on its website.

These norm-based and sector-based exclusions are poignant because they involve significant volumes of assets and highlight the possibility of hindering access to capital for certain businesses with particularly harmful extra-financial externalities.

⁹ "State parties" are those that have ratified the treaty.

Ex-post analysis: assessing the ESG quality of a non-SRI fund

From a technical standpoint, investment managers are able to assess the extra-financial aspects of a number of traditional equity portfolios through available access to relatively broad universes of ESG analysis - at least for European large caps. Amundi refers to their "ESG footprint". The regularity and systematic coverage of these ratings varies widely from one investment manager to another, depending on the internal objectives and institutional clients' expectations. That said, 90% of those surveyed currently have some sort of access.

This type of approach has a definite influence, albeit not a direct impact, on the financial management of a fund and can take several forms:

- Warning the manager of the most obvious extra-financial risks incurred in managing the investment.
- Assessing the ESG characteristics of a non-SRI fund can lead to the "conversion" to SRI of some funds with high ESG ratings (what OFI AM did for two large funds in 2009) or the option to convert to SRI in the case of separate account management.
- Defining a target for improvement or selection of the best ESG performer without affecting financial considerations. This is the practice by BNP Paribas Assurance for its euro-denominated fund worth EUR 65 billion.

This first group of practices is in direct response to asset owners concerned about exposure to reputational risk and controversy due to their investment policies. In some ways, this mirrors the initial phases of SRI funds, when institutions (notably religious congregations) were concerned about the social acceptability of their investments and examined the practices of the companies in which they invested, ruling out the most highly criticised sectors.

ESG integrates financial analysis

Investment managers currently apply practices that tend to integrate ESG externalities into the valuation of securities and quantify how some ESG issues impact the return/risk trade-off of a given investment. To do so, they develop ESG screening and try to apply it to all of their assets under management.

Outpour of ESG information

The set-up of in-house teams dedicated to studying ESG issues has gradually raised the awareness of finance teams in recent years. These specialised teams communicate on a daily basis with managers and financial analysts by participating in meetings in-house or with companies, notably those with brokers. This ESG awareness is now combined with more structured factors. Most respondents (76%) state that they provide all managers and financial analysts with ESG information. Two other investment managers plan to do so in 2010 (bringing the proportion to 84% of our sample). ESG information is communicated through the following tools:

- in-house analyses;
- a database focused on extra-financial research available to all teams;

- a grid simultaneously showing financial and ESG reviews by sector for all sector companies. Inter Expansion, an investment management subsidiary of the welfare group Aprionis, has done this for the automotive sector, for example¹⁰:

		Financial analysis		
		Positive	Neutral	Negative
SRI analysis	Positive	BMW Michelin	Scania	
	Neutral		Fiat Pirelli Renault	Valeo Volkswagen
	Négative		Daimler Peugeot	

- the integration of key ESG data (particularly ratings) directly into managers' financial dashboards. Three major investment managers (Amundi, Groupama AM and Natixis AM), whose total assets amount to over EUR 800 billion, have already implemented these types of tools. Notably, Amundi's extra-financial analysts have developed a database interfaced with the traditional management platform so that all Amundi managers have access to companies' ESG ratings, as well as those of other issuers (governments, financial institutions, etc.), alongside financial and credit ratings.

The structure of teams is another way of encouraging the distribution of ESG information. In 2003, Groupama AM's extra-financial analysis and credit analysis teams were brought together in the same department. At Inter Expansion, the SRI research team has been working within the equity management team since 2008. HSBC Global Asset Management or Dexia AM have an extra-financial analysis department comprised of experts to furnish information as efficiently as possible to both SRI and traditional management teams. Dexia AM points to its joint research produced by financial and extra-financial analysts on the impact of ESG issues on the long-term value of companies. Lastly, Amundi has focused all of its extra-financial analysis and research expertise on its specialised subsidiary IDEAM. SRI managers are integrated directly into mainstream management teams.

The joint participation in in-house committees can also fuel dialogue between SRI specialists and pure finance experts. By providing the opportunity for mainstream managers to take part in committees specialised in extra-financial issues (e.g. Agicam or Dexia AM) or SRI specialists to take part in investment committee meetings (Fédéris Gestion d'Actifs or Inter Expansion), issues can be debated directly between the two sides, thus further raising awareness of ESG issues.

¹⁰ Source: Inter Expansion

CNP Assurances has taken an original stance by not having any in-house extra-financial analysts. The sustainable development teams and financial teams (internal finance department and external managers since it is delegated management) have a concrete exchange on ESG integration.

Finally, investment managers like HSBC Global Asset Management communicate ESG culture to mainstream managers by offering them training programmes such as "Enlightened Self-Interest - Solutions for Responsible Investors", a one and a half hour session on responsible investment developed by Responsible Investment Association Australasia (RIAA). Amundi has included ESG issues in a series of Amundi Campus lectures available to all staff members.

Impact of ESG issues on financial analysis

There are several approaches. The most common aim to integrate specific extra-financial issues whose materiality has been established:

- Detecting companies or governments particularly exposed to an identified ESG risk through extra-financial screening, most often on governance, with a view to removing them from the investment universe. This is referred to as minesweeping at HSBC Global Asset Management, a blacklist at Financière de Champlain, or extreme risk identification at Agicam.
- Identifying the best-positioned companies on a key sector issue. This analysis pinpoints proactive companies with regard to a given ESG issue and turn it into a competitive edge.
- The best effort approach¹¹, which refers to spotting companies that have made the most progress and discerning favourable value-boosting trends in the medium to long term. This can also mean detecting any potential decline that gives rise to a risk of devaluation (dual approach used by Axa IM).

A number of the firms surveyed carry out research on key criteria. They are then integrated into the risk management, more specifically interest rate risk, but they could also be used to detect investment opportunities. Rather than focus on mere extra-financial risk management, some managers should seek out the business leaders in the segments of the future or identify the companies for which ESG approaches will be growth drivers and increase in value in the medium to long term. ESG integration should not be reduced to simple risk management.

Other players go a step further, systematically integrating issuers' ESG ratings in their assessment alongside financial analysis. Fédéris GA, investment manager of the welfare group Malakoff-Médéric, breaks the assessment of European companies down as follows: 20% for ESG rating, 40% for valuation and 40% for the growth outlook, which automatically eliminates most securities with poor extra-financial ratings. Two of the five analysis pillars used by Financière de l'Échiquier represent extra-financial concerns. Governance was included in their analyses from the outset, which now excludes the worst governance practices and lack of transparency, and a review of environmental and social issues was added in 2007. Finally, SAM (subsidiary of Robeco) is unique in that it is both an extra-financial ratings agency and investment manager. At inception, extra-

¹¹ Funds that use the best effort approach seek out investments whose practices remain flawed but are actively working towards concrete improvement, rather than focusing on the most virtuous players in terms of ESG criteria.

financial valuation is an integral part of the financial valuation and is reflected in a gain or loss in company valuation.

These practices show how differently clients - asset owners - and their suppliers - investment managers - perceive ESG integration. Investment managers try to reap maximum benefit from the extra-financial research produced by SRI funds to adjust the valuation of securities and risk exposures with regard to growing or established ESG concerns. Moral issues expressed by some of their clients are left to SRI funds to handle. This may be a sign of the financial management to come, with, thanks to SRI, the integration of all ESG issues with an impact... on financials. Although it remains difficult to determine the exact impact of these approaches, they suggest that a significant proportion of managers are ready to integrate new variables that bring them in line with the real economy. Then we may ask *why* more asset owners are not taking these considerations into account. In light of the review of practices and the expectations of asset owners active in this area in France, organisations that strongly emphasise their social values clearly focus on preserving their reputation and avoiding controversy, rather than considering the medium- and long-term impact of ESG issues.

IV.

Identified SRI funds and ESG management through variable geometry

The volume of assets suggests that the SRI market has not reached its critical mass, that financial markets have not yet fully harnessed the value of integrating ESG issues. ESG integration volumes are higher, but SRI and ESG integration should not be combined to inflate the amount of assets under management. Fundamental differences between them remain, and must remain in the future.

There are two types of structural differences between SRI and ESG integration:

- 1. Selection of securities. In SRI, this process is documented and combines ESG and financial aspects systematically and restrictively. In ESG integration, it is a non-restrictive approach performed on a case-by-case basis.**
- 2. Scope of application. It is clearly identified for SRI funds, while borders are sometimes blurred in the global management of ESG integration.**

ESG integration lacks standardised processes

Investment managers may be very open to distributing extra-financial information to their mainstream teams, but are less so when it comes to defining specific targets for using and systematically taking into account ESG issues along with financial aspects. The actual impact of distributing and incorporating extra-financial information as part of ESG integration remains difficult to assess.

Some companies are technically capable of monitoring the use of ESG analyses - especially those with a dedicated database - but none of the companies surveyed claimed to do so. This may be to encourage dialogue between managers and extra-financial analysts in a more educational approach. Otherwise, they would simply have direct access to data whose impact they do not fully understand. Furthermore, if the limits set are not clear, they may end up being applied incorrectly. These exchanges cannot be quantified, which makes it challenging to transform the availability of extra-financial information into concrete targets for systematic integration. Only two groups in the sample (Groupama AM and Caisse des Dépôts) include qualitative targets related to the teams' integration of extra-financial issues into their assessment criteria, confirming these difficulties.

SRI funds, however, remain clearly identifiable because they follow a documented process that provides traceability of the impact of extra-financial aspects on the management process.

Another fundamental difference is that ESG integration covers extra-financial issues whose economic or financial impact is known and may disregard major social issues, a mistake thus far avoided by SRI thanks to global analysis tools. The actual impact of a

great number of issues must be analysed in order to determine the key issues. HSBC Global Asset Management highlights the example of relations with local communities, often considered to be a social issue with no direct economic impact. For example, a mining company has just been refused the right to continue its operations in Bolivia due to complaints from local communities that have escalated to the national government. In analysing only the obvious criteria (CO₂ quotas, major pollution, etc.), major ESG issues can be overlooked.

A concrete example of this risk is the UK retail chain Tesco, which had defined a sustainable development strategy focused on climate change. It was voluntarily committed to CO₂ emissions targets but covered up the issues related to the working conditions in its supply chain. Tesco rapidly lost credibility in the eyes of well-informed stakeholders, NGOs and especially SRI investors. This demonstrates that a global sustainable development policy must focus on more than climate change alone to be credible.

Clearly defined scope of application for SRI

Unlike what the acronym SRI (Socially Responsible Investment) suggests, it specifically concerns funds. Few players believe that SRI can apply to all asset management. However, ESG integration can theoretically encompass all asset management, in line with the PRI.

Approaches still vary widely between firms, which is confirmed by statistics from PRI assessments¹². ESG integration remains far from covering all asset classes. The latest report noted that:

- Integration primarily concerns equities for both asset owners and investment managers.
- Fixed-income products, especially those issued by governments, and hedge funds post a lesser degree of integration.

Regarding unlisted securities, ESG issues have sparked greater interest in the past few months. As analyses of unlisted companies are for the most part unavailable, private equity managers tend to guide the companies in which they invest on incorporating ESG issues rather than set up more restrictive SRI funds. They do so through their relations with the management team.

New issues are raised as ESG integration spreads to more investment strategies. In light of the success of structured or guaranteed funds that claim to be SRI, how relevant is this approach for complex financial products?

What about derivatives and structured products?

In theory, ESG integration aims to cover all assets, so it should be extended to complex financial instruments. Or should it? A few of the issues raised are given below:

- One of the purposes of ESG integration is to bring the real economy into consideration. However, practices that are not based on a real investment in securities of an issuer, but tend to involve options (short selling) or index-based (index or performance swaps, etc.) instruments, make extra-financial screening quite unreal.

¹² See *PRI Report on Progress 2009*

- Instruments with a high leverage effect and increased risk exposure, even if the securities have been subject to extra-financial screening, qualify more as speculative investments and less as responsible investment, which is inherent to SRI and ESG integration.
- The practices (governance, transparency, reliability) of the counterparty, generally a bank, issuing a derivative also impact how responsible its use is. The counterparty should therefore be screened for its adherence to ESG integration in the same way as the underlying assets are.

Despite the many questions arising from these investments, applying ESG integration to derivatives should not be completely ruled out. The types of products and their use within the fund would have to be closely monitored for them to qualify. Increased visibility would be needed with regard to the underlying assets, counterparties and any use of the leverage effect so that the level of risk remains that indicated in the literature given to investors. Lastly, the purpose of these instruments would have to be assessed within an investment strategy that incorporates ESG issues. This would ensure that it is indeed an investment rather than only financial products and that the derivatives are used for hedging certain market risks rather than pure speculation.

V.

Standardising ESG integration

Although ESG integration often stems from practices developed as part of SRI management processes, the two approaches are different in a number of ways. A clear distinction must be made to avoid any distortion of either practice.

ESG integration is gaining ground, and some questions need to be answered regarding the purpose of these approaches.

From ESG integration to SRI

There is disagreement as to how ESG integration may become SRI.

A number of managers consider that the communication of ESG criteria aims to increase their incorporation into global management specifically for converting existing funds to SRI. In 2009, CAAM Group began the gradual conversion of "classic" funds to SRI. In 2009, CAAM Group began the gradual conversion of "classic" funds to SRI. It intends to pursue this strategy within the new entity, Amundi. Société Générale Gestion, which is currently integrating Amundi, is taking a comparative approach based on the ex-post rating of some of its non-SRI funds. ESG convictions often emerge even in some traditional funds, particularly when their manager also covers an SRI fund. These funds are not identified as SRI funds as long as the company has not made its SRI management strategy official but could easily be converted.

OFI AM also seems to be shifting from ESG integration to SRI. The monitoring of ESG criteria has extended to a growing number of securities since 2005, but SRI management is limited to funds of funds. The in-house process was gradually structured, resulting in the conversion to SRI of two of the company's major funds in 2009.

Financière de l'Échiquier seems to be following the same path. Securities began to be screened for ESG criteria in 2007 but without the objective of setting up or converting to SRI funds. As an ESG integration approach is currently harder to sell to third parties, especially clients, than well-identified SRI funds, the company is examining SRI more seriously.

Financière de Champlain has set a timetable to gradually apply ESG restrictions and turn all of its equity funds into SRI funds by 2011. This decision was based on the useful insight gained through the two SRI funds launched in 2006.

However, for most of the managers surveyed, SRI will remain a niche for only a handful of clients with special requirements, while ESG integration aims only for long-term value creation. The latter approach means taking into account externalities that are not included in traditional financial analysis. SRI funds cover a significantly wider array of ESG criteria. This makes them particularly useful as an "R&D laboratory" to identify the criteria to be taken into account in mainstream management. Extra financial analysts only consider issues that may have a short or medium term impact and not necessarily those that will have an impact in the future (e.g. the ramifications of electromagnetic waves or nanotechnologies).

The FRR has distinguished between the two since its inception in 2004. It began with a EUR 600 million SRI test. When it renewed its investment strategy in 2008, the FRR went a step further by gradually applying ESG screening to all of its assets. This two-step approach was copied in the world of collective insurance. MAIF also chose to adopt an SRI approach (equity funds delegated to external investment managers) while gradually strengthening ESG integration for the bonds it manages directly.

This trend of combining ESG integration with SRI may lead to confusion and misrepresentative marketing of the ESG practices actually implemented. According to the SRI screening criteria of some managers, 80% of the companies in the Eurostoxx50 index have good ESG practices. As such, investment managers can boast an SRI approach based only on ex-post measurement, without a more structured process.

On the positive side, most of the firms interviewed by Novethic do not seek to call SRI what is not SRI. The difference between ESG and SRI is essential for those that have developed SRI expertise as the investment objectives are not the same. This must also be clear when presenting these two approaches to third parties. CM-CIC AM has observed a genuine interest in ex-post ESG ratings of non-SRI portfolios from private banking sales staff and from the network of estate management advisors (*Conseillers en Gestion de Patrimoine* or CGP). Ecofi Investissements has noted an interest in this type of assessment of its capital from its parent company, Crédit Coopératif. Both investment managers intend to proceed with caution, clearly indicating their fear that the marketing effect will overwhelm operational practices. While warmly welcoming this demand, they are working to promote genuine ex-ante SRI management.

Is strategic allocation the next target for ESG integration?

In 2009, the FRR published a study that assessed the impact of different climate change scenarios on its assets between now and 2040. The study lay new ground for combining ESG integration with strategic allocation for long-term investors. Working on a single criterion considered to have the most available scientific data, climate change, the FRR was seeking to design a new approach to improve how extra-financial parameters could be linked to the weighting of different asset classes, such as the shares of listed companies, private equity, real estate or forests.

Similarly, the financial advisor Mercer developed ESG expertise and began research on how to meld ESG criteria with strategic asset allocation for a Norwegian fund, the Government Pension Fund-Global, one of the most active investors in the world in terms of ethical investment and engagement with excluded companies.

As yet, neither the FRR nor the Norwegian fund has turned this initial theoretical research into anything concrete in terms of asset allocation. This is partly due to financial obstacles, as is the case for other asset owners. Insurers have liquidity and security constraints that restrict asset allocation so much that extra-financial aspects are often left by the wayside.

Hurdles to standardising ESG integration

Investment managers and asset owners seem to genuinely want to integrate ESG criteria, but they face reluctance and major hurdles to get there. Hindrances can be

technical, from a financial or extra-financial point of view, or organisational, not to mention simply the lack of interest in this type of approach.

Innovation abounds in extra-financial screening

Over the past ten years or so, extra-financial analysis has grown considerably as has SRI funds. However, the coverage of the securities analysed and the quality of research do not always satisfy financial actors accustomed to financial analysis models that have been standardised for about fifty years and cover most listed companies and issuers of financial securities across the globe.

Many investment managers complain of the unavailability of structured, persuasive ESG information on bond issuers, particularly financial institutions and governments, issuers from emerging countries, small and mid caps and unlisted companies.

The frequency with which extra-financial data is updated poses another problem, as ratings from specialised agencies are only updated yearly at the most.

Furthermore, it is extremely difficult to compare the extra-financial analyses of different issuers, even similar issuers rated by different agencies, due to the lack of any global benchmark. One solution could be the norm-based exclusion of the worst practices based on the United Nations Global Compact and the Fundamental Principles and Rights at Work of the International Labour Organization, for which there seems to be some consensus.

Assessments of governments are questioned due to the relevance of the criteria used and the political ramifications of excluding a government. CNP Assurances believes that governance represents a viable criterion for governments, provided the lack of democracy or lower level of development does not overly penalise governments, as is the case in currently available ratings. The other pillars (environment and social) are still a greater problem.

Extra-financial analysis has thus far avoided the major conflict of interest of being financed by the issuer of the securities. The lack of resources and regulations to harmonise the extra-financial communication of issuers may, however, undermine its development. A number of investment managers are gradually setting up small teams of specialists which will eventually overcome these technical obstacles in the years to come. Following the example of an insurer such as BNP Paribas Assurance, extra-financial rating agencies can seek new clients among asset owners, enabling them to ensure the viability of their economic model, which has been difficult to do thus far, and promote their development.

Organisational hurdles

Most managers technically have access to extra-financial information. Management teams, notably those focused on asset classes that are less developed in terms of SRI, are far removed from ESG aspects for which their interest remains limited. The lack of awareness of ESG issues and training on the use of the tools available can be corrected through simple instructional efforts. For example, HSBC Global Asset Management provides instructions on how to use the tool to share ESG information used by its financial analysts and managers. Responsible investment practices are emerging in some asset classes like private equity, suggesting that no asset class or investment strategy can ignore ESG considerations in the long run.

Technical restrictions of portfolio management

Many managers are reluctant to introduce additional constraints or extra-financial investment objectives because they must already comply with technical requirements. These include tracking error¹³, which restricts them to a portfolio breakdown in line with their benchmark index. Moreover, extra-financial data is not updated frequently enough, especially when it comes from specialised rating agencies, to be fully integrated into traditional financial reviews which are revised almost daily.

Some investment strategies also present a problem. A value driven manager¹⁴ will be more reluctant to accept the exclusion of a security that is deemed financially under-valued, especially in restricted investment universes where opportunities need to be taken. In contrast, those in favour of ESG integration argue that the ESG issues themselves should drive the revaluation of securities in the short and medium term (e.g. in the case of corrected governance following controversy). They suggest specific investments in this case based on a best effort approach.

Lastly, insurers are extremely limited as the so-called Solvency II regulations considerably restrict any changes in their existing portfolios in terms of dispersion, security and liquidity, leaving little room for ESG issues.

Financial performance objectives

The debate over the impact of the integration of ESG issues on the financial performance of a portfolio started with the first SRI funds. Myriad academic and professional studies have examined the issue, but no real consensus has emerged. It is often admitted that the SRI approach does not destroy value¹⁵, but that is not enough to encourage managers to integrate it across the board. Some believe that extra-financial issues, particularly governance, can have advantages in specific cases but not for all investments. CNP Assurances regrets that topics such as climate change are not the subject of more detailed extra-financial analysis and do not have any real effect on the valuation of securities. Unable to quantify the impact accurately, the insurer feels that it is not responsible for the CO₂ emissions of all of the companies in which it invests and prefers to focus its extra-financial approach to governance.

There is a growing international debate about the relationship between fiduciary responsibility and extra-financial issues¹⁶. We hope that this will encourage asset owners to lead the way in supporting ESG integration for its advantages in terms of long-term performance factors such as risk management and investment opportunities.

Major obstacles remain regarding the industry-wide standardisation of ESG integration. They confirm that those who proclaim full ESG integration too quickly are the most likely to be guilty of false advertising. It is reassuring that most of these hurdles can be overcome by making headway in research or collaborative approaches like those initiated within the framework of the PRI.

¹³ The tracking error measures the relative risk taken by a fund as compared with its benchmark index.

¹⁴ Portfolio investment strategy that selects securities considered under-valued with regard to sector ratios.

¹⁵ Demystifying Responsible Investment Performance, a statistical analysis produced by Mercer in 2007 and updated in 2009, reviewed several academic studies available on the subject. Twenty-two out of 36 studies showed a positive impact of ESG on financial performance, 8 a negative impact and 6 a negative impact.

¹⁶ See the UNEP-FI report *Fiduciary responsibility: Legal and practical aspects of integrating environmental, social and governance issues into institutional investment*, July 2009.

Conclusion

In the meetings and interviews it conducted as part of this study, Novethic's research centre confirmed the current development of ESG integration.

Today, most leading asset managers and a large number of independent firms have noted this in the bids from asset owners.

Concrete examples include the assessment of the ESG quality of non-SRI portfolios, the extension of extra-financial research, the availability of ESG information for financial management teams or the application of norm-based exclusion. ESG integration covers all of these rapidly developing approaches that currently impact either directly or indirectly at least EUR 2.46 trillion in assets under management in France. Impressive, considering the SRI market weighs in at less than EUR 50 billion. ESG integration is expected to gain ground, with many investors announcing that they want to continue or even step up their efforts in 2010 and 2011.

An important distinction must be made between ESG and SRI: unsystematic constraints and therefore a lack of traceability on choices between financial and extra-financial criteria. However, the potential to extend to greater volumes of assets is tremendous, levels that SRI will probably never reach. These two approaches share a common goal: use the financial driver to encourage companies to apply proactive ESG strategies and more generally a sustainable development model.

Novethic noted in its interviews with investors that the notion of the sustainability or social responsibility of the economic players was virtually absent from the debate. Their clients tend to endorse the motivation of financial impact or reputational risk. Is this why shareholder activism¹⁷ is so rare in France? Another risk is that the objective of financial materiality will disregard very long-term issues in favour of only extra-financial criteria with an established impact on companies and public organisations. Finally, the lack of requirements and clarity as to the effectiveness of ESG integration also continue to be debated, and the risk of false advertising is never far away.

These reservations confirm how vital it is to maintain exacting, structured SRI funds. They are an R&D tool and a niche that can gradually drive ESG integration to cover all financial assets as traditional managers begin to internalise ESG issues. As such, Novethic only considers practices with a systematic impact on management in its annual review of the French SRI market.

¹⁷ Shareholder activism refers to the dialogue between a shareholder with the company to encourage and improve its ESG practices. When this private dialogue does not result in the intended outcome, the investor brings the debate to the public arena through general shareholders' meetings.

Companies surveyed

Novethic's SRI research centre based its study on interviews with about thirty companies active in the different financial management businesses.

Name	Type of organisation PMC = Portfolio Management Company	PRI signatory
Amundi (Crédit Agricole AM Group)	PMC part of a banking group	2006
BNP Paribas Investment Partners	PMC part of a banking group	2006
CM-CIC Asset Management	PMC part of a banking group	No
Dexia Asset Management	PMC part of a banking group	2006
Ecofi Investissements	PMC part of a banking group	2009
Federal Finance (Crédit Mutuel Arkéa)	PMC part of a banking group	2009
Fédéris Gestion d'Actifs	PMC part of a banking group	2008
HSBC Global Asset Management	PMC part of a banking group	2006
La Banque Postale AM	PMC part of a banking group	2009
Natixis Asset Management	PMC part of a banking group	2008
Société Générale Gestion	PMC part of a banking group	2006
AXA Investment Managers	PMC part of an insurance group	2007
Groupama Asset Management	PMC part of an insurance group	2006
OFI Asset Management	PMC part of an insurance group	2008
Agicam (Groupe AG2R La Mondiale)	PMC part of a pension and welfare fund	No
Inter Expansion (Aprionis group)	PMC part of a pension and welfare fund	No
Financière de Champlain	Independent PMC	2008
Financière de l'Échiquier	Independent PMC	2008
BNP Paribas Assurance	Asset owner (insurance)	No
CNP Assurances	Asset owner (insurance)	No
MAIF	Asset owner (insurance)	2009
Caisse des Dépôts	Asset owner (state)	2006
ERAFP ¹⁸	Asset owner (state)	2006
Fonds de Réserve pour les Retraites (FRR)	Asset owner (state)	2006
Eurosif	Professional organisation	-

For information purposes, 65 investment managers state that they are active on the SRI market in France and 35 have signed the PRI.

¹⁸ *Établissement de Retraite Additionnelle de la Fonction Publique*, French Public Service Additional Pension Scheme.

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A PART OF CAISSE DES DÉPÔTS ■

Achieving investment objectives through ESG integration

Study conducted by Dominique Blanc, Aela Cozic and Samer Hobeika,
Novethic SRI Research Centre.

Novethic, part of Caisse des Dépôts, is a research centre in France on Corporate Social Responsibility (CSR) and Socially Responsible Investment (SRI) and a sustainable development media expert.

Set up in 2001, today Novethic is the exclusive source of statistical information on the French SRI market. The SRI research team conducts thematic studies, analyses product trends and assesses the SRI processes of asset management firms. Novethic initiated a label for SRI funds available on the French market in 2009.

Novethic

56, rue de Lille - 75007 Paris - France
Tel.: +33 (0)1 58 50 98 14 – Fax: +33 (0)1 58 50 00 30
E-mail: info@novethic.fr
www.novethic.com