PROBUS SIGMA Lda

ESG PROTOCOL & COMPLIANCE FOR INVESTMENT MANAGERS

VERSION 1.7

Probus sme VERIFIED : BY PROBUS SIGMA ESG V ™

Important Note:

This Probus Sigma ESG Protocol sample pack is designed to illustrate the overall scope and rigour of this programme. It further serves to demonstrate scalability.

References to pages, sections, modules and other features made within this sample pack serve to illustrate the breadth of content of the actual Protocol but for brevity, this content is omitted for this sample.

The technical developers of this programme understand that some investment managers may not be fully conversant with ISO technical terms or indeed Environmental, Social and Governance, (ESG), terminology, therefore as far as possible technical terminology has been reduced.

The Probus Sigma ESG Protocol facilitates choice of appropriate rigour (and cost) related to investment risk, it provides a variety of options and methodologies, all fully ESG compliant for investment purposes but appropriately graded.

The published Protocol pack contains a comprehensive set of spread sheets related to each Guide. These spread sheets have all the necessary content and calculation capability to provide a complete ESG risk analysis of any potential individual investment or complete portfolio.

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PREAMBLE

Clearly defining the key risk differentials between; sustainably based ESG, Green, Eco, Ethical, Socially Responsible Investment (SRI), Corporate Social Responsibility (CSR) and Responsible Investment (RI).

ESG AS AN INVESTMENT TOOL

The emergence of sustainably based ESG as an investment tool needs to be clearly distinguished from the field of Socially Responsible Investment (SRI) and other similar terminology.

The fundamental distinguishing feature between these two approaches is motivation. Whereas SRI is essentially motivated by ethical imperatives and aims to actively shape the market, ESG integration is motivated by economic imperatives and is a risk-analytics tool aimed at capturing the effects of environment, social and corporate governance considerations on the risk-adjusted return of portfolios. In this regard, ESG integration is arguably a more tangible and effective method of addressing such issues given conventional investment practice, which relies heavily on quantitative measures and standardised benchmarks.

SRI literature has a long history stretching back to the 1980s where it had strong uptake amongst European funds such as the Stewardship Fund in the United Kingdom and Varldnaturfonden in Sweden (Louche and Lydenberg, 2006). The attempt behind these early funds was to focus investment in assets that were regarded by those investors as 'socially responsible'. From the practitioner perspective, sell- side analysts were engaged in constructing portfolios that satisfied a particular appetite for non-financial goals. Within the academic literature, however, defining which investment goals are 'socially responsible' has been contested based on different moral, ontological, ideological, and functional definitions of social responsibility (Sandberg et al., 2009). SRI has been used to describe investment portfolios that achieve a sufficient level of financial return as well as offering social, environmental and other non-financial benefits (Sparkes and Cowton, 2004). This definition of SRI is fundamentally politicised because each investor, as a consumer of financial products, demands their own mix non-financial goals and outcomes making the construction of a commonly agreed upon 'SRI portfolio' impossible (Davis and Thompson, 1994, Hendry et al., 2007).

Separately to this prerogative, a body of literature has developed on the *economic* consequences (as opposed to the ethical consequences) of social, environmental and corporate governance variables on the financial performance of the investments. This literature has spawned many streams of academic research in finance, law (Black and

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Coffee, 1994) and management (Davis and Thompson, 1994). On the one hand, quantitative research has been carried out trying to use social (Orlitzky et al., 2003), environmental (Bauer et al., 2005) or governance (Bauer et al., 2008) variables to explain shareholder returns. This literature at times has faced methodological challenges by virtue of the fact that often environmental, social or corporate governance data has been located within SRI-related products, either in an aggregated fashion or in the form of *self-assessed* qualitative metrics. This has given reason to qualify the conclusions of much of this quantitative research. On the other hand, the literature has focused on the ability of ownership rights and shareholder activism to change corporate management. This literature has mainly focused on changing company's governance in light of Jensen and Meckling's (1976) agency theory (Clark and Hebb, 2004, Hebb, 2008, Neubaum and Zahra, 2006). Whatever limitations may be placed on the conclusions reached by this research, it is clear that the underlying economic motivations of this research stream fundamentally distinguish it from the ethical overtones of the SRI literature.

ESG integration has emerged as an investment tool that clearly falls within this latter economic-focused literature and is better defined by financial academia. Championed to a large extent by the United Nations Environment Programme Finance Initiative and major sell-side investment houses around the world such as Goldman Sachs, UBS, and JP Morgan, ESG integration is a new investment tool which is focused on risk analytics and identifying long-term 'alpha' drivers (above benchmark returns). In other words, it is about more precisely determining the impact of environmental, social and corporate governance considerations on asset pricing and the future cash flow of businesses. As such, it is a split from the primarily social/ethical/market-transforming mandate of the SRI community and as such has attracted some consternation from academics within this community.

The importance of ESG integration in financial analysis is partly grounded in the failure of financial actors to fully price the value of quantitative data regarding a firm's environmental, social, and governance performance into asset pricing (Clark and Knight, 2009). Furthermore, it is also grounded in the shortcoming of financial valuation models, for example discounted cash flows, to capture the growing *intangible* asset base of new paradigm firms, including the effect of qualitative ESG considerations on firm valuation.

[1] For instance, the book value of assets in the S&P 500 only account for 20-25% of corporate valuation (Ned Davis Research 2007). The remainder is represented in intangible assets such as future innovation, reputational value, good will, and relationships (Clark and Salo, 2008). Intangible assets have been identified as a

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relatively larger proportion of the asset base of 'new paradigm' firms as opposed to 'classical model' firms, which are largely reliant on physical and tangible assets (Clark and Salo, 2008).

The growth of the intangible asset base highlights the importance of continuous innovation of products, processes and organisations designs for new paradigm firms (Lev, 2001). ESG considerations share a close synergy with firms' intangible assets especially to the extent that they encompass new product markets, for example, alternate energy production, General Electric's campaign to sell its 'Eco-magination' product line in 2008-2009 or the growth in sales for hybrid cars for the Toyota Motor Corporation in 2006-2008. Another example is the strong relationship between strong environmental performance and a firm's reputation amongst consumers and stakeholders, as demonstrated by the losses suffered by Royal Dutch Shell following the Brent Spar incident (Esty and Winston, 2006, Gunningham et al., 2003) and more recently The BP disaster. All leading 'ESG' ratings agencies had BP in their top ranking 'ESG' performers. However the underlying calculations to support this position were entirely SRI based and not ESG based. These serve to illustrate how the emergence of ESG integration is in close harmony with the emergence of new paradigm firms and the growing importance of intangible assets, and other factors such as reputation and legitimacy, in certain sectors and geographies.

With exposure to a wide variety of asset types and geographies over a long time horizon, asset owners such as pension funds may have the potential to improve their overall returns by taking into account various considerations into their investment choices. However, given the relative recent rise of ESG integration as an investment tool available in financial markets, its uptake, is partly contingent on the ability of investment consultants to understand and engage with ESG in advising their clients, and to convince clients of the potential merits of ESG integration. This is because investment consultants are uniquely positioned to collaborate with trustees (or investment boards) and direct the flow of fund assets, utilising ESG considerations.

[1] A 'New paradigm' firm is a term which has emerged in the management literature to describe the unique business model of numerous firms over the past 25 years. The market valuation of these firms involves intangible assets such as good will, corporate reputation and brand valuation. These assets mean that the firm's market valuation is at a significant premium to the firm's book value. This is in contrast to "classical model" firms which dominated the early 20th century. Here, market valuation is closer to book valuation because the firm's assets where primarily physical and tangible assets such as plant and equipment. CLARK, G. L. & SALO, J. 2008. Corporate governance and environmental risk management: a quantitative analysis of 'New Paradigm' firms. *In:* QUARTER, J., CARMICHAEL, I. & RYAN, S. (eds.) *Pensions at Work: Socially Responsible Investment of Union-Based Pension Funds.* Toronto: University of Toronto Press.

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ORGANISATIONAL COHERENCE OF ESG

Market leading consultants, such as Probus Sigma, with the most specialised knowledge of ESG are confident to relate ESG to their clients in economic terms. They have the language to explain how ESG considerations can have a material impact on corporate financial performance and therefore on portfolio performance, as the following response indicates:

"An increasing body of evidence exists to show that ESG factors impact investment performance…. We believe ESG factors fall within the purview of fiduciary duty where they are or may be material to long term capital preservation. ESG factors also contribute to the growth of investments as related opportunities are sought."

The strength of ESG knowledge varies across sector, geography, investment strategy and asset classes and market leading ESG consultants are able to position themselves in relation to clients as 'leaders' who could guide their client through this complex terrain.

The lack of ESG expertise place the consultant in a weaker position in the client relationship, but it is also consistent with conceptual confusion about what ESG integration actually means.

Specifically, in a recent Probus Sigma Study of 150 'ESG' consultants, 90% confused ESG with SRI, which meant that they conceived of ESG in ethical rather than economic terms.

Further studies revealed that ESG integration is more important in asset classes exposed to long-term trends such as long-term long-only equities. As such, investment strategies that are highly geared towards short-term returns will fail to integrate these long-term dynamics into their allocations and will therefore be exposed to higher long-term risk profiles.

Although it is not impossible to generalise these conclusions, there is certainly empirical evidence to suggest that meaning of terminology such as SRI, corporate social responsibility (CSR) and responsible investment (PRI) is highly conflated amongst pension funds and that there is substantive confusion on the distinction between the ethical and economic issues at play (Aging, 2008). As such, the investment cultures within the pension fund setting deserve further research.

Categorising issues as ethical rather than economic, SRI investment consultants may lead clients away from considerations, which in fact have a very tangible impact on financial returns and risk. Empirical research on trustee board decision-making has shown that when issues are framed in terms of ethical responsibility, trustees are less responsible than average members of the public (Caerlewy-Smith et al., 2006). The lack

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of knowledge around ESG integration is most pronounced around the key areas of measuring environmental and social issues as opposed to corporate governance, which has a deeper history in the academic literature (Bauer et al., 2008). One comment recently given by a moderately experienced consultant indicated that when an ESG issue is apprehended in financial terms, then the consultant is willing to promote its importance in investment management.

Knowledge and long term ESG expertise therefore are crucial when choosing ESG consultants.

Greater levels of experience and knowledge influence the level of leadership ESG consultants feel comfortable to exercise over clients, and the extent to which they are able to provide more robust professional services. Lack of knowledge, by contrast and SRI confusion leads to situations of active harm, (BP), where conceptual confusion means that crucial considerations involved with the measurement of ESG risk are discarded in favour of SRI expediency.

Notwithstanding the difficulties in forming networks of communication around ESG integration, leading consultants are beginning to develop tools to assist asset owners to form and evaluate relationships with asset managers. For example, consultants have begun to rate fund managers based on their ESG competency in parallel with overall investment rating. Evaluation takes place routinely and takes into account both quantitative and qualitative data such as "idea generation, portfolio construction, management and implementation". This information is compiled into global databases about global investment managers in a manner which is comparable and standardised. Processing information and applying evaluative metrics can be understood as the first step towards taking leadership for clients on these issues (Lowenstein, 1996). This is consistent with Lowenstein's (1996) contention that financial agents are only able to manage what they can measure.

Moderately experienced ESG consultants are to a larger extent reliant on the client to express an interest in ESG integration before expertise is forthcoming. Indeed these consultants only provide ESG integration advice on demand and have no full-time institutional capacity in this issue. The short supply of ESG expertise may also be correlated with poor quality advice in the sense that 90% of 'ESG' consultants confuse ESG integration's economic motivations with SRI's ethical motivations.

Consultants who lacked expertise on ESG integration to confuse it as an ethical issue rather than an economic issue is concerning. This error is highly problematic in light of the fact that trustee boards have a weak appetite for ethical considerations (Caerlewy-Smith et al., 2006). Therefore ESG integration presented to trustees in this manner is likely to be dismissed to the fund's financial disadvantage.

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