ESG Integration Practices: Research Results

Valoris/JHU SEA Research Initiative

June 2022

Valoris Stewardship Catalysts

Johns Hopkins School of Advanced International Studies

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1. Executive Summary

Research Background

- The SAIS Social Enterprise Accelerator (SEA) conducted this research on Stewardship and ESG Integration practices among a group of asset managers worldwide between November 2021 and March 2022, under the direction of Valoris Stewardship Catalysts. Data on approximately 36 asset managers and input from 8 asset owners was collected through public sources and interviews.
- A diversity of asset managers was selected based on:
  - Size - 33.3% are small asset managers with an AUM of less than $1bn, 52.8% are medium-size asset managers with an AUM of $1bn - $10bn and 13.9% are larger asset managers with an AUM of more than $10bn),
  - Investment strategies (private equity only – 25% of managers, 75% of managers included public equities investments),
  - Public commitment to high standards on stewardship (evidenced by PRI, or similar, membership – 2/3 of participants) and
  - Investment targets being in developed or emerging markets, in single or multiple countries.
- While the study did not aim to be scientific, the anecdotal results are instructive and can serve as a basis for further analysis and action by asset managers.
- Individual data and opinions collected from research participants, except for publicly-available information, is kept confidential and will not be disclosed.

High-Level Findings 1

- Some 80% of studied asset managers have an in-house or externally-engaged ESG-focused team members, providing services that include training, policy advice, investment analyses and portfolio support, which indicates a rather high level of organizational integration.
- Although 2/3 of interviewed asset managers (14) engaged consultants on ESG integration aspects such as ESG integration policy and investment/portfolio support in the last 3 years, only 7 managers said they plan to engage consultants in the next 12 months, indicating a limited appetite for external expertise on stewardship.
- Even though almost all asset managers in the study have some form of ESG/stewardship policy in place, the PRI-signatories tend to have standalone ESG policies while non-signatories usually have integrated policies.
- Most asset managers in the research, irrespective of size, asset class or PRI membership, use investment analysts to conduct ESG research. While 14 out of 22 asset managers have a dedicated ESG staff, in 4 of those firms the *investment analysts* are leading the ESG data collection and analysis with no involvement of the ESG staff.

High-Level Findings 2

- Investment strategy (i.e., private equity-only asset managers) and size of asset managers (i.e., larger firms) appear to be positively correlated with the use of dedicated ESG staff to lead portfolio engagement activities. The top 3 most common portfolio engagement activities are board/c-suite engagement, sharevoting and engagement with ESG specialists of investees.
- PRI-signatory asset managers are more likely to report to their investors on their portfolio engagement activities and outcomes, including on climate risks, than asset managers with no formal public commitment to stewardship. The non-PRI signatories are typically not using any specific reporting metrics or frameworks.
- Select interviews with research participants showed that the majority of asset managers believe that ESG integration helps with outperformance.
- Demands from asset owners were cited as a common impetus for ESG integration by asset managers.

High-Level Findings 3

- Most commonly-cited challenges reported by asset managers (18 respondents) included:
  - Growing number of regulatory frameworks posing a challenge to standardizing internal processes (7 respondents),
  - Limited in-house capacity to handle an increasing number of complex ESG disclosure requirements (6 respondents) and
  - The lack of available ESG data on the medium and smaller companies (6 respondents).
- Interviews with 8 large asset owners showed that their expectations for ESG integration of their external asset managers are *relatively similar* across the board, with common features including requiring adherence to a set of high-level principles guiding ESG investment, proxy voting, engagement and ensuring that ESG integration takes into consideration an alignment of risk and return.
- Asset owners often require or recommend their asset managers to subscribe to certain ESG principles (incl. PRI), and/or required the adoption of ESG investment frameworks and disclosure practices (incl. TCFD).
- Identifying greenwashing, the multiplicity of disclosure standards and transparency gaps in self-reported data were mentioned as key challenges for asset managers, while cybersecurity, geopolitical risks, and diversity, equity and inclusion were cited as top priorities for asset owners.

Valoris
Stewardship Catalysts

2. Project and Team Introduction

Asset Managers' ESG Integration Research Initiative

- The Project was conducted by the Social Enterprise Accelerator (SEA) program participants from Johns Hopkins University, School of Advanced International Studies, with the sponsorship, guidance and oversight of Valoris Stewardship Catalysts.
- Objective:
  - To better understand the ESG integration policies and practices of diverse (mostly small and mid-size) asset managers with input from selected asset owners.
- Data Modality:
  - Information was collected through desk research, questionnaires and interviews with select asset managers and asset owners.
  - Individual data and opinions collected from research participants, except for publicly-available information, is kept confidential and will not be disclosed.
- Research Period:
  - The project was conducted from November 2021 to April 2022.

Project Implementation Process

Phase 1: Asset Managers

- Research and interviews with 21 asset managers were conducted to understand their ESG integration objectives, policies and practices and detect patterns and possible trends.

Phase 2: Asset Owners and Additional Asset Managers

- Research and interviews with 8 asset owners were conducted to understand their investment strategy, asset allocation, and ESG integration expectations and requirements from their asset managers.
- Desk research was conducted on additional 15 asset managers based on their most recent PRI Reports, expanding the asset manager sample size from 21 to 36.

SEA Research Team

Nathan Shapiro
1st-Yr MAIR

Experience:
Intern at Albright Stonebridge Group; Practice Coordinator with the Venture Capital practice at Polsinelli PC; Case Assistant at Foley Hoag LLP supporting international trade and venture practices.

Subi Suvetha Velkumar
MIEF

Experience:
Intern with the IFC; Intern at International Innovation Corps with the National Digital Health Mission; Capabilities & Insights Analyst at McKinsey & Co.

Joshua Simangunsong
MIEF

Experience:
Consultant at Deloitte; Co-Founder of AgraiCulture; Agricultural Economist for Peace Corps Perú; Analyst at JPMorgan; Head of Farming at Siman & Co.

Moe Phyu
2nd-Yr MAIR

Experience:
Intern at the Anthesis Group working on sustainable supply chain and operations; Research Analyst (Short-Term) at the IFC Development Impact team; Graduate Consultant at Women Deliver, Research Intern at Greenpeace East Asia.

Anna Rolsma
MIPP

Experience:
Director of Finance at Good Machine Studio, Entrepreneur mentor at ReefGen, Unison, and Balloon Tech Co., Director of Operations and Finance at Pelagic Data Systems.

Introduction to Valoris

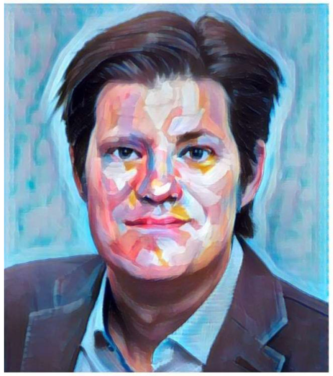
Valoris Stewardship Catalysts is an advisory firm that provides expertise and support to institutional investors and financial institutions to design and execute strategies for evaluating environmental, social and corporate governance (ESG) factors in their decision-making and engage with clients and investee companies.

- **Focus themes: Governance, Stewardship and Sustainability**
- **Investor-Focused**
- **Practitioners (i.e., not academics/ consultants)**
- **Global and regional, developed and emerging markets**
- **Understand the clients' perspective to tailor services to their needs**
- **Combine strength in content, process, customization, documentation and capacity-building, private sector and public policy perspectives**

The Valorians -Managing Directors

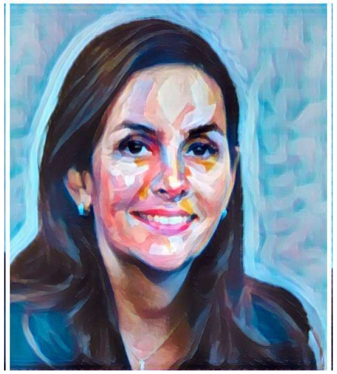
Mike
Lubrano

Co-Founder of Cartica Management LLC and IFC's Corporate Governance Unit Expert in ESG integration and training.



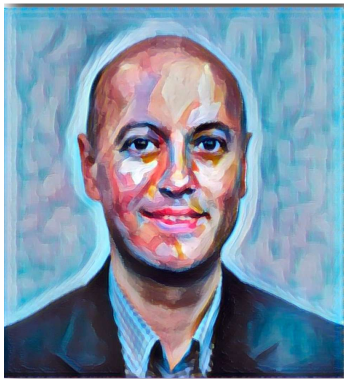
Martin
Steindl

ESG and Corporate Governance Expert with the FMO (the Dutch Development Bank) and IFC. Expertise in climate change risk management and human rights due diligence.



Mariangeles
Camargo

Accredited Internal Auditor and Expert in Sustainable Finance and "green" financial products, multilateral institutions and Environmental and Social Management Systems.



Davit
Karapetyan

Expert in Corporate Governance Due Diligence with the IFC, development of internal GSS policies, procedures and training for IFC and DFIs.

Read our full biographies at
www.valoriscatalysts.com

3. Key Findings

Diverse Asset Managers Included in the Research

- The research on Stewardship and ESG Integration reviewed practices of 36 asset managers and collected input from 8 asset owners between November 2021 and March 2022 through public sources, questionnaires and interviews.

- A diverse group of asset managers was selected based on:
  - Size - 33.3% are small asset managers with an AUM of less than $1bn, 52.8% are medium-size asset managers with an AUM of $1bn - $10bn and 13.9% are larger asset managers with an AUM of more than $10bn),
  - Investment strategies (private equity only – 25% of managers, 75% of managers included public equities investments),
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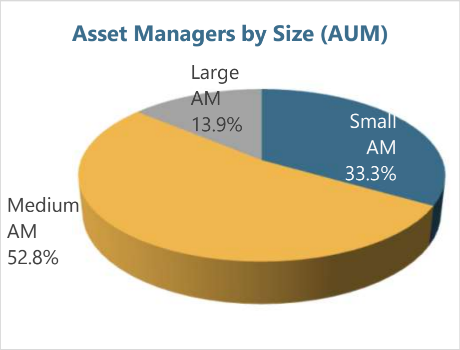
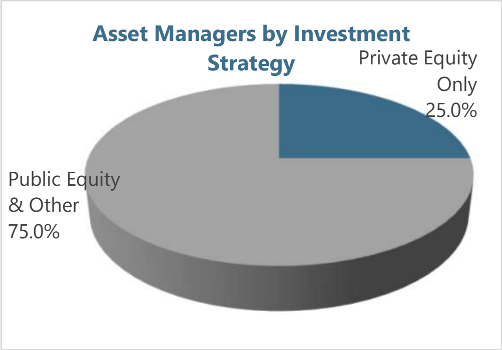
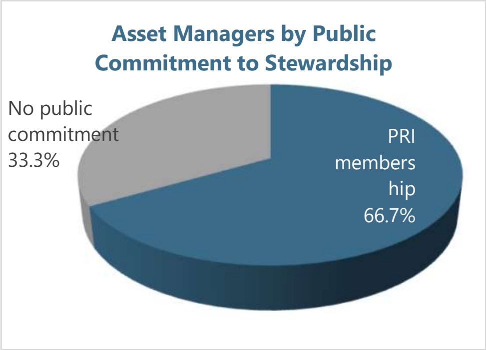
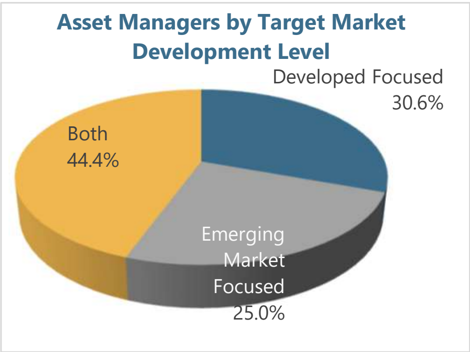


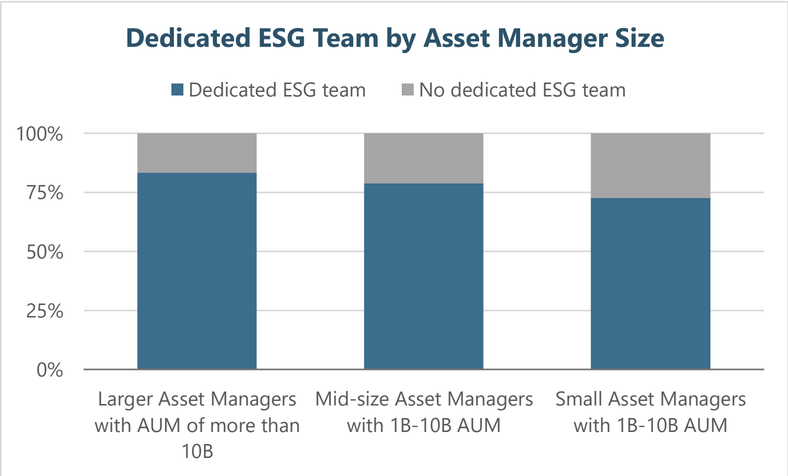


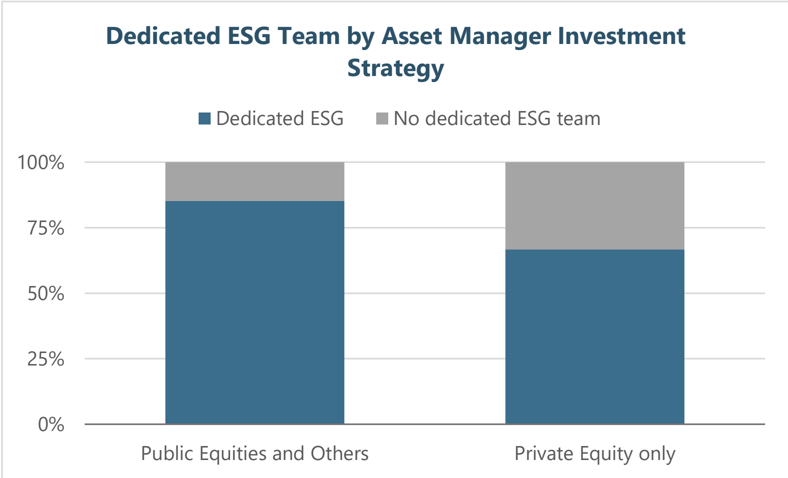




Asset Managers Are Hiring ESG Analysts

- Some 80% of studied asset managers have an in-house or externally-engaged ESG-focused team members, providing services that include training, policy advice, investment analyses and portfolio support, which indicates a rather high level of organizational integration.

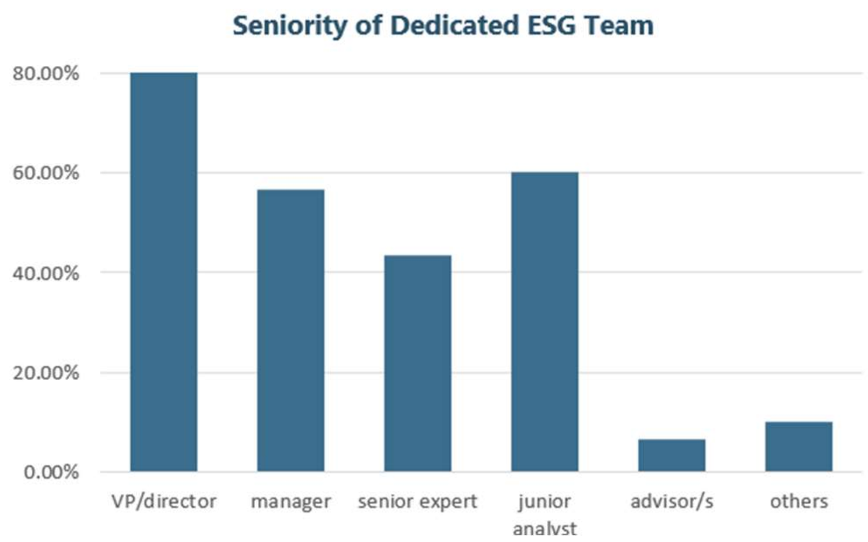




ESG Team Members are Fairly Senior

Sample size: 30

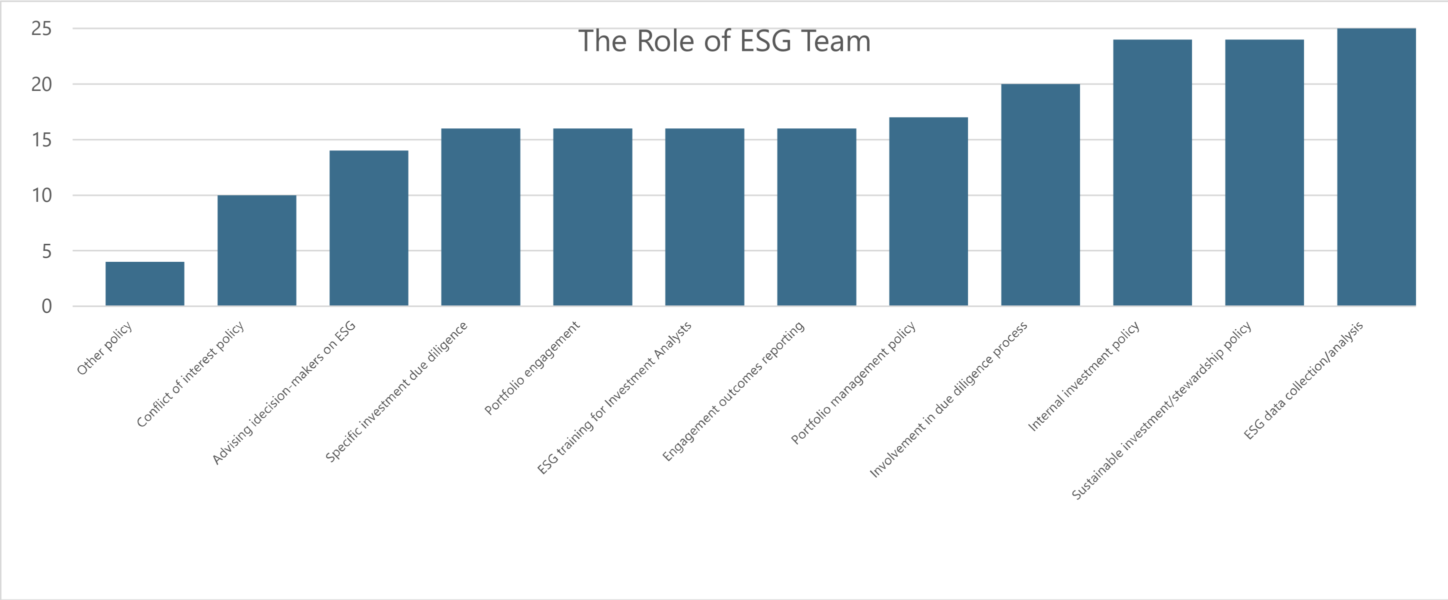
- 80% of asset managers have a VP or a Director-level staff overseeing ESG issues.
- Common titles of other staff include Head of ESG and Sustainable Investments, Head of Legal, and Chief of Staff.



ESG Staff Deal with Internal/Policy Issues and Investment Analyses

Sample size: 30

- The top 2 responsibilities of ESG staff are ESG data collection/analysis and drafting the stewardship policy. The bottom 2 are drafting conflict of interest policy and advising investment committee on ESG matters.

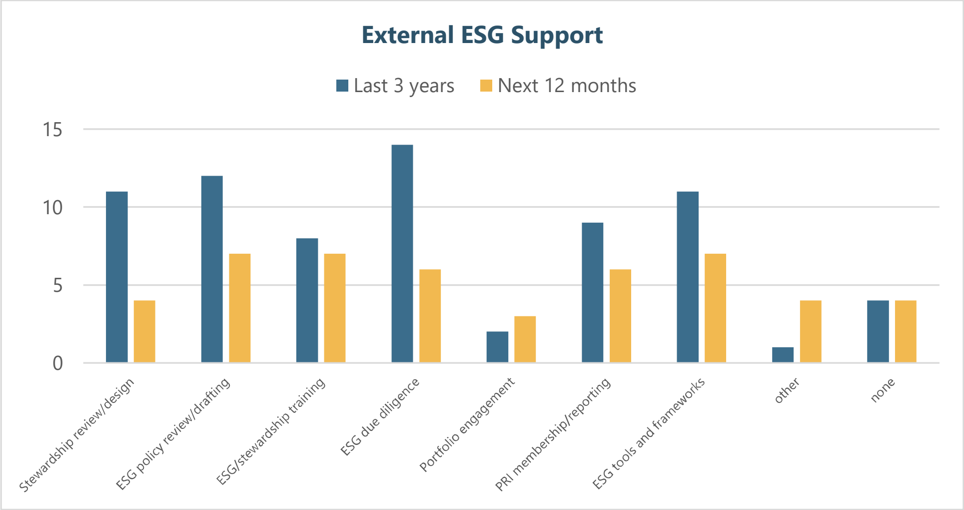


External ESG Integration Support is Underutilized

- Although 2/3 of interviewed asset managers (14) engaged consultants on ESG integration aspects such as ESG integration policy and investment/portfolio support in the last 3 years, only 7 managers said they plan to engage consultants in the next 12 months, indicating a limited appetite for external expertise on stewardship.

ESG support engaged in the last 3 years:

- ESG investment/portfolio client due diligence;
- ESG/stewardship policy review/drafting

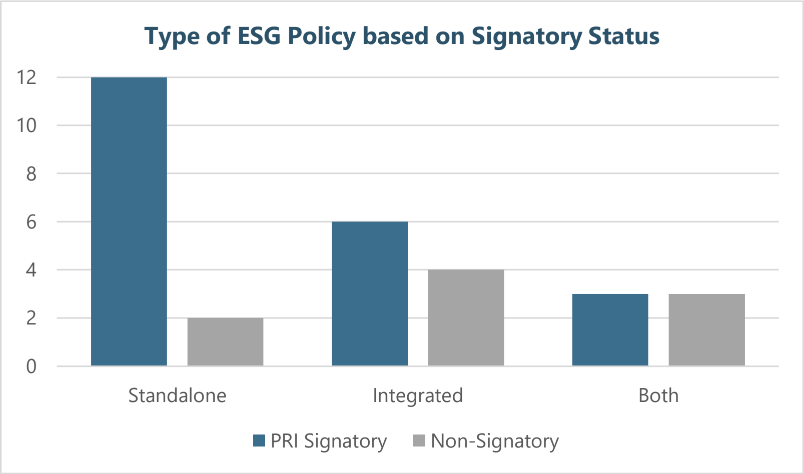


ESG support needed in the next 12 months:

- ESG investment/portfolio client due diligence - ESG/stewardship policy review/drafting
- ESG training
- ESG tools and frameworks for due diligence, data, and outcomes

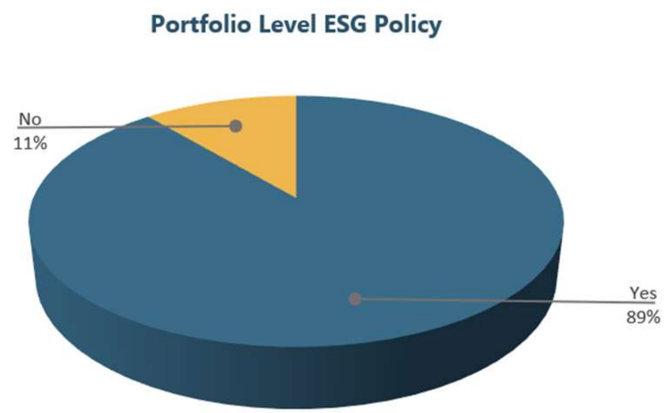
Asset Managers are Adopting Some ESG Integration/Stewardship Policies

- Even though almost all asset managers in the study have some form of ESG/stewardship policy in place, the PRI-signatories tend to have standalone ESG policies while non-signatories usually have integrated policies.



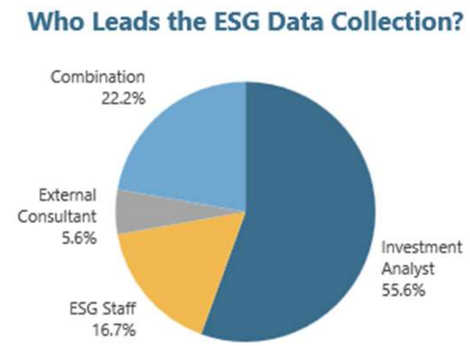
Portfolio Engagement Policy is More Common at Public Equities Managers

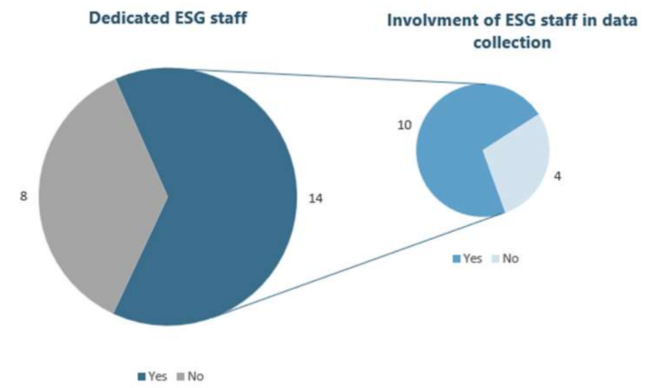
- Around 90% of the asset managers report following some form of engagement policy. Out of the sample of 27 asset managers, only 3 report not having any formal portfolio engagement policy.



Investment Analysts Lead ESG Analyses for Investment Decision

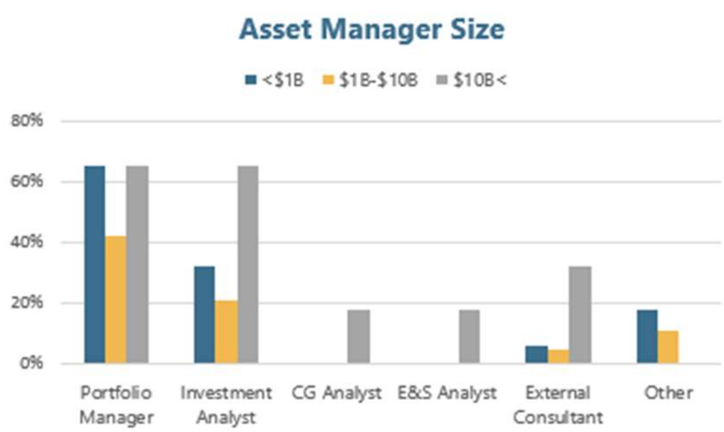
- Most asset managers in the study, irrespective of size, asset class or PRI membership, use investment analysts to conduct ESG research. About a quarter of managers use specialized ESG analysts.
- While 14 out of 22 asset managers have a dedicated ESG staff, in 4 of those firms the *investment analysts* are leading the ESG data collection and analysis with no involvement of the ESG staff.

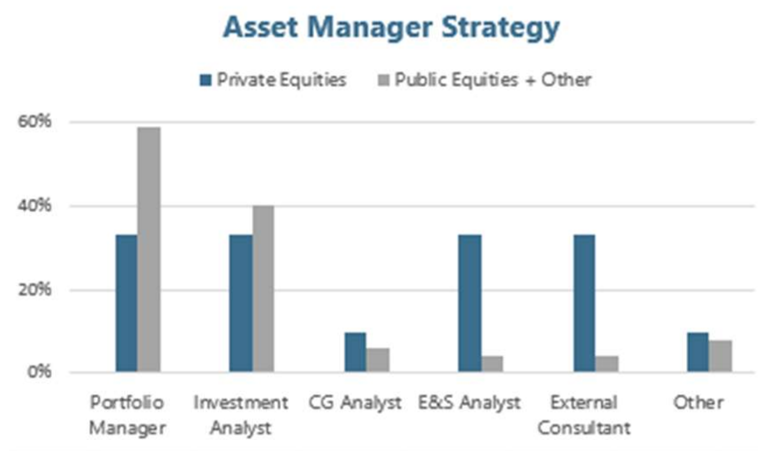




Smaller Managers Use Specialized ESG Staff for Portfolio Engagement

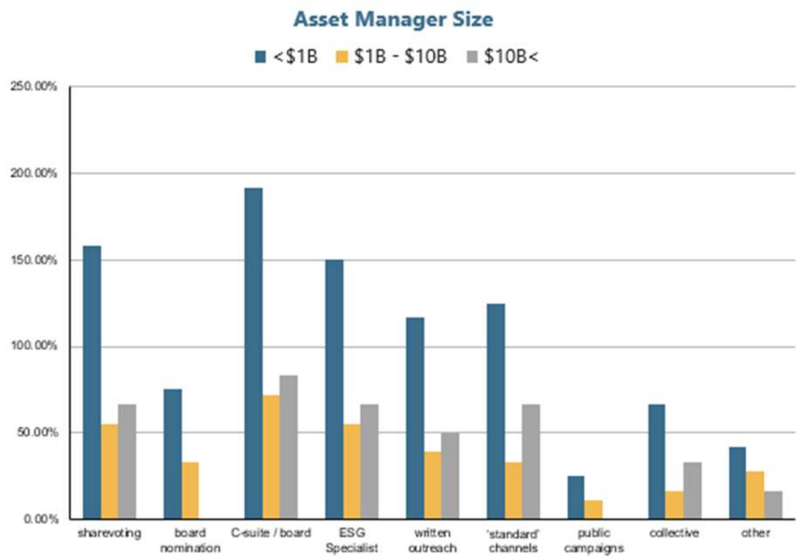
- Investment strategy (i.e., private equity-only asset managers) and size of asset managers (i.e., larger firms) appear to be positively correlated with the use of dedicated ESG staff to lead portfolio engagement activities.
- Asset managers with public equities strategies tend to rely on their internal analysts and portfolio managers, while private equity firms often use external consultants.





Sharevoting and Board/C-Suite are Most Common Engagements

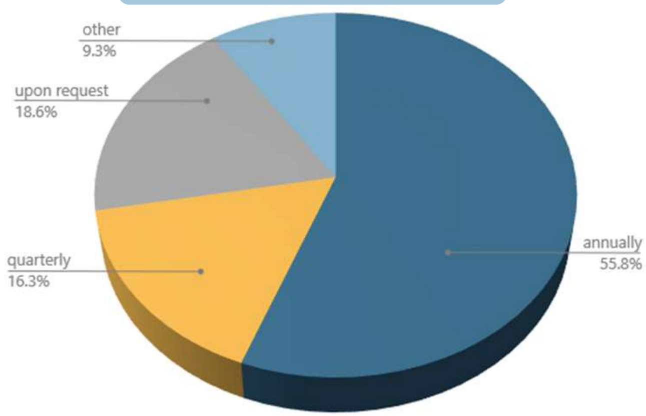
- The top 3 most common portfolio engagement activities are:
  - Board-C-suite engagement;
  - Sharevoting; and
  - Engagement with ESG specialists of investees.



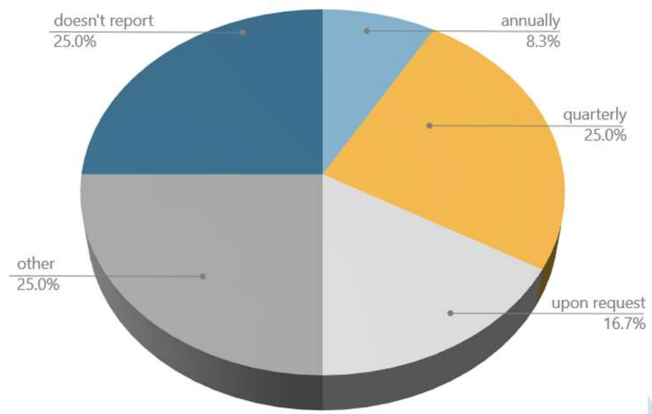
Public Commitment to Stewardship Correlated with Better ESG Reporting

- Asset managers that have a public commitment to a recognized stewardship benchmark/framework, such as PRI, are more likely to report to their investors overall on their portfolio engagement activities and outcomes, including on climate risks, as well as more frequently than asset managers with no formal public commitment to stewardship, whereas the non-PRI signatories are not using any reporting metrics. A quarter of non-PRI signatories do not report at all.

PRI Signatories

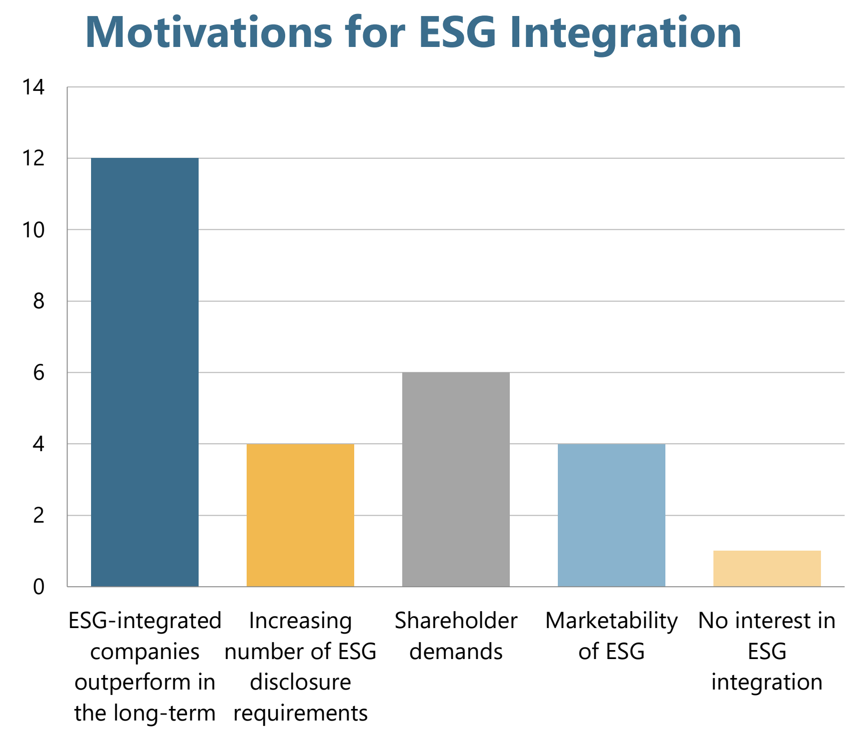


Non-PRI Signatories



Outperformance Due to ESG is Recognized

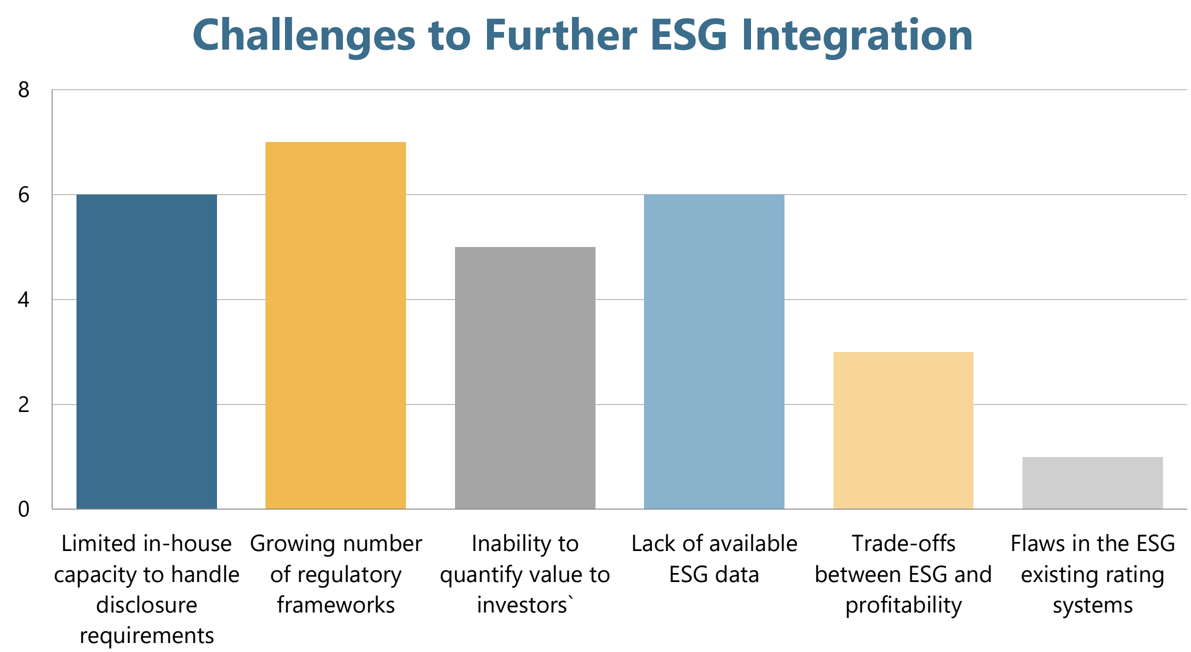
- Interviews with study participants showed that the majority of asset managers (12 out of 20 interviewed) believe that:
  - ESG integration helps with outperformance and
  - Is commonly driven by demand from institutional investors.



Regulatory Complexity, Lack of ESG Resources/Data Are Key Challenges

Key challenges to better ESG Integration cited by asset managers (18 respondents) include:

- Growing number of ESG/Stewardship regulatory frameworks (7),
- Limited in-house capacity to handle an increasing number of complex ESG disclosure requirements (6) and
- The lack of available ESG data on the medium and smaller companies (6).



Asset Owners Push for Greater ESG Integration of Their Asset Managers

- Interviews with 8 large asset owners showed that their expectations for ESG integration of their external asset managers are *relatively similar* across the board, with common features including:
  - Requiring adherence to a set of high-level principles guiding ESG investment,
  - Proxy voting,
  - Engagement and
  - Ensuring that ESG integration takes into consideration an alignment of risk and return.
- In some cases, asset managers are required to be signatories to certain ESG standards (incl. PRI), and/or required the adoption of ESG investment frameworks and disclosure practices (incl. TCFD).

Challenges & Priorities for ESG Integration – Asset Owner Views

Challenges:

- Identifying Greenwashing
- Multiplicity of Disclosure Principles
- Transparency Gaps in Self-Reported Data
- Lack of Data in Emerging Markets
- Developing Universal ESG Standards
- Competing Priorities & Risk Mitigation

Top Priorities:

- Cybersecurity
- Geopolitical Risk
- Diversity, Equity and Inclusion
- Executive Compensation
- Infrastructure

4. Valoris's Stewardship Solutions

Why is ESG Integration / Investor Stewardship* Important?

Outperformance and value-add: Empirical studies demonstrate that companies with better ESG practices tend to outperform their peers with poor ESG performance. Therefore, investments in better run companies from an ESG perspective can generate better returns for fund managers and fund investors.

Structured and consistent approach to analyzing ESG risks and opportunities: ESG risks and opportunities need to be considered at each stage of the investment cycle. Ensuring that this is done consistently, coherently and systematically is key to efficiency and effectiveness.

Compliance: Current or proposed regulations may require investors to take ESG and sustainability factors into account in their investment decisions. Stewardship includes thoughtful engagement around material ESG matters. Additionally, asset owners increasingly seek reporting and data on the ESG footprint of their fund managers.

Leadership and reputation: Integrating ESG considerations throughout the investment and portfolio processes sets fund managers apart from their peers and helps attract ESG-conscious asset owners and retail investors.

*Stewardship is commonly defined as the responsible management of something entrusted to one's care.

Valoris's Stewardship Solutions

- **"Investor Stewardship Assessments"** against ICGN GSPs, other standards, and asset owner expectations (incl. benchmarking against practices of other asset managers)
- **"Tailored Stewardship Methodologies and Toolkits",** including policies, scorecards, questionnaires, voting guidelines, reporting frameworks, etc.
- **"Plug and Play Solutions"** for collecting, analyzing, aggregating and reporting ESG information on prospects and portfolio companies
- **"Stewardship Capacity-Building"**, including staff training on ESG, Stewardship and the asset manager's own methodology and tools
- Outsourced **ESG due diligence** and **engagement**

Value-Add for Throughout the Investment Cycle

- ESG/Sustainability Policies and Procedures, integrated into operational policies and procedures
- Definition of internal and external ESG expertise needed – ESG skills assessment
- Enhancing ESG capacity of the relevant team members
- Training materials

- Key questions and indicators for decision-making
- Tailored tool for data collection, analysis and output

- Internal and external reporting on ESG and engagement activities - templates

- Key questions and indicators for decision-making
- Tailored tool for data collection, analysis and output
- Material ESG indicators to track in portfolio
- ESG improvement/engagement plan sample

- Material ESG indicators/data to track in portfolio
- ESG improvement/engagement tracker – sample
- Reporting and Disclosure:

Stewardship/ESG Integration into Investment Life-Cycle

THE INVESTMENT PROCESS

Designing an Effective Methodology

- Prospect identification
- Investment decision
- Portfolio engagement
- Reporting

Incorporating ESG data into investment decision-making must be tailored to each investor's particular asset class, investment beliefs, return objective, risk appetite, investment style and time horizon

Talents, expertise and experience of staff also need to be considered in designing an ESG integration and stewardship methodology

Models exist and are useful, but each investor needs to tailor the inputs, analytical tools and outputs to its own needs

Making Sense of ESG Data, Standards and Ratings

- Prospect identification
- Investment decision
- Portfolio engagement
- Reporting

The amount of ESG data continues to increase exponentially

Standards have proliferated

Ratings have limited value

Companies and investors can be overwhelmed

Harmonization is underway, but very much a work in progress

Investors need to be selective in the sources they draw from and how they use ESG data in their investment process

Monitoring, Engaging, Voting and Reporting

- Post-investment stewardship should build on pre-investment ESG analysis
- Institutional investors should have a systematic approach to monitoring individual and aggregate ESG risk in the portfolio
- Engagement on sustainability issues is a natural extension of a comprehensive ESG methodology
- Stewardship reporting is still nascent but advancing. Institutional investors must prepare for what's around the corner

5. Conclusions

Conclusions

- While the study was not intended to generate statistically robust results, the research provides useful anecdotal information on ESG integration.
- We identified observable differences in ESG integration policies and practices when comparing asset managers of different sizes, investment strategies, shareholders and public commitment to stewardship.
- Key Takeaways:
  - Asset managers and asset owners face growing number of ESG frameworks, guiding principles and best practices, posing a key challenge to developing a standardized practice for ESG integration.
  - Asset managers and asset owners have signaled that access to accurate, reporting-quality ESG data poses a significant hurdle for integration, especially for those firms investing in emerging and frontier markets.
  - Expected regulatory changes will bring more pressure on asset managers to implement better ESG integration but also help guide them throughout the journey on a more consistent basis.

Contact us

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