

ESG: Road Blocks or the Road to Integration?

Recent international forums such as COP21 and the World Economic Forum (WEF) have drawn increased attention to global economic risks arising from corporate environmental, social and governance (ESG) practices and performance. In particular, WEF concluded that climate change was the greatest global risk in their latest survey¹ and made a call to action for ESG integration by investors. The global drive towards considering ESG factors as core components of business and investment strategies gains momentum year-on-year as it becomes accepted that ESG is relevant and important for sound long term decision making.

What are the road blocks to ESG integration?

ESG integration is not without its perceived challenges by companies and investors alike.

Companies often cite a lack of questions from analysts on quarterly calls as a dis-incentive to disclose further ESG information or to put additional efforts into verifying the data. On the other hand, investors also state the lack of adequate, reliable and consistent disclosure by companies as a hindrance to incorporating ESG.

Some investors have in the past also argued that there is insufficient evidence that ESG adds value and that incorporating these policies may even go against their fiduciary duty to maximize returns to beneficiaries. Are these arguments substantiated or is the reality quite different?

¹ World Economic Forum, *Global Risks 2015 Report*, <http://reports.weforum.org/global-risks-2015/>

No investor interest?

Contrary to the perception by some companies, there is a growing focus by the largest asset owners and asset managers globally in integrating ESG considerations across all their assets. The Global Sustainable Investment Alliance (GSIA) through its large network of national and regional investment associations has been measuring the size of assets that incorporate ESG factors and in 2014 this represented US\$21.4 trillion², about 30% of professionally managed assets globally, this is up from US\$2.6 trillion in 2002. Put another way, seven of the ten largest pension funds in the world are now signatories of the Principles for Responsible Investment and hence now aim to consider ESG factors across all assets.

In analyst calls and meetings the questions may not be termed 'ESG', however when there are questions on staff turnover, major industrial accidents or the incentive structure of management, these all relate to ESG factors. The questions and focus may also come from other parts of the investment chain and outside of quarterly result meetings.

Changing benchmarks and passive allocations may also go undetected by companies. It is common for the largest asset owners to integrate ESG factors into their indexes, benchmarks and mandates, for example FTSE Russell now calculates a large number of these custom benchmarks for its clients. Companies will often be oblivious to these benchmarks and index tracking funds whilst the questions from brokers and analysts catch their attention.

Against fiduciary duty?

In the past there was much confusion between what is 'ethical investment' and ESG integration into investments. Linked to this, asset managers and advisers have often cited fiduciary duty as a reason for not incorporating ESG factors into the investment decision-making process; claiming non-financial indicators were not investment relevant and instead only reflected particular people's personal values.

Recent studies have broadened the interpretation of fiduciary duty and have emphasized that there is no intrinsic conflict between fiduciary duty and ESG considerations. Despite these outdated perceptions continuing to exist in significant pockets of the investment industry there is a generally accepted recognition that ESG issues are investment relevant and therefore should be considered by fiduciaries. In some markets this is being clarified by regulators and those providing market oversight.

The 2015 UK Law Commission's Report on the fiduciary duties of investment intermediaries found that consideration of environmental, social and governance factors by pension trustees was entirely consistent with their fiduciary duty to beneficiaries. This position was also endorsed in the United States following an October 2015 revision to the Employee Retirement Income Security Act (ERISA). Enacted in 1974, ERISA sets out minimum standards for private sector pension and health schemes in the U.S. One key issue is the definition of a scheme's fiduciary duty. Following this change the law now considers that ESG integration is not at odds with a pension scheme's fiduciary duty.

² Global Sustainable Investment Alliance, *Global Sustainable Investment Review 2014*
http://www.gsi-alliance.org/wp-content/uploads/2015/02/GSIA_Review_download.pdf

This position is also reinforced through the development of Stewardship Codes that encourage investors to deepen their interaction and engagement with investee companies on strategic issues. The UK Stewardship Code was first unveiled in 2010 by the Financial Reporting Council and other Stewardship Codes have since been adopted in a variety of other countries including South Africa, Switzerland, Italy, Holland, Japan and Malaysia, influenced by the UK version. A key component of these Codes is to enhance constructive engagement on issues including how the investee company addresses risks arising from social and environmental matters, or governance.

Beyond the obstacles: the road to integration

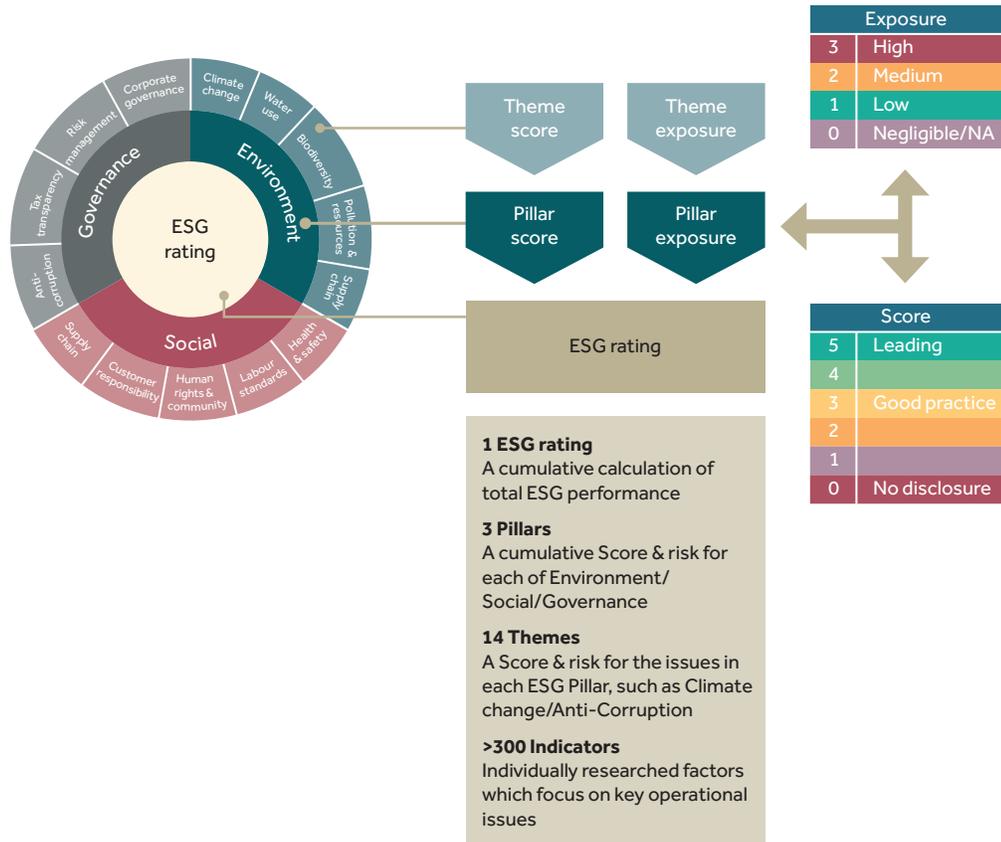
In order to support the growing interest in ESG the most crucial challenge facing participants is to understand what ESG information should be considered as part of the investment decision making process and how to interpret it.

There are two different lenses to evaluate and assess a company. First, there is the ESG approach which focuses on a company’s operational activities and how well they address the specific ESG risks to which the company is most exposed. Secondly, the Low Carbon Economy (LCE) approach focuses on the source of a company’s revenues and if it contributes positively to a low carbon economy.

ESG	LCE
<p><i>How does the company operate?</i></p> <p>To what extent does the company take a proactive approach to long term business risks from environmental, social and governance factors to its business operations?</p>	<p><i>What does the company manufacture?</i></p> <p>Does the company provide goods, products or services that, through their utility, enable society to adapt, mitigate or remediate the impacts of climate change, resource depletion or environment erosion?</p>

Applying an ESG framework

The integration of ESG data into investment processes places increased importance on the availability, consistency and reliability of the information provided by companies. FTSE Russell helps drive the alignment of standards globally, for the benefit of investors and companies, by drawing from the leading international standards and frameworks for each 'ESG Theme' for which companies are evaluated. The FTSE Russell ESG framework has a strong focus on the identification of material themes so that the methodology becomes tailored for each company evaluated.



Source: FTSE Russell

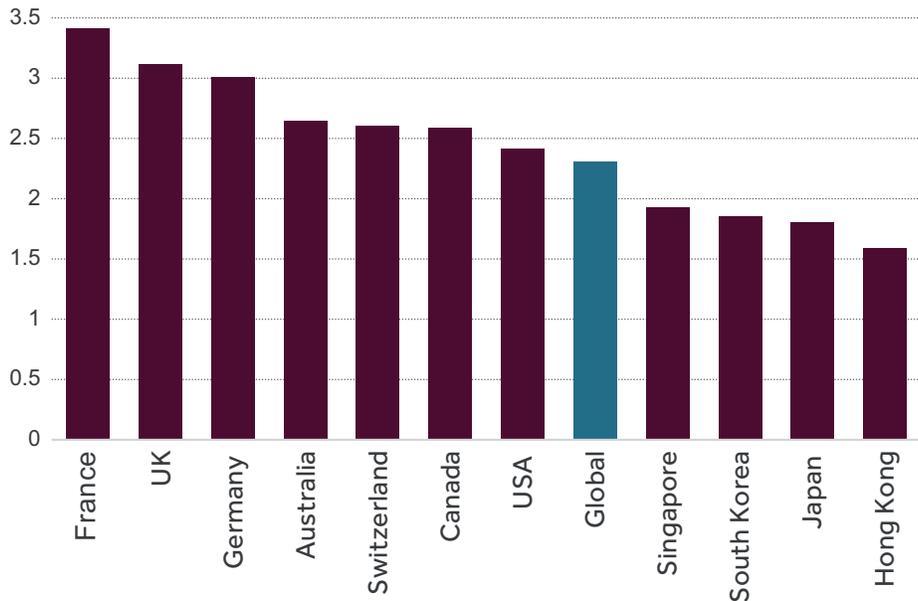
FTSE Russell's ESG Ratings can assist the investment process in several ways, including:

- **Engagement and Stewardship:** Identifying companies with high exposure and low scores which could mean that a company is facing business risks from not managing material 'ESG Themes'
- **Integration into active investment decisions:** Identifying factors considered alongside other fundamental data
- **As a basis for ESG indexes:** This can be either one of FTSE Russell's current indexes such as the FTSE4Good Global Index or on a custom basis
- **Manager selection and evaluation:** Asset owners such as pension funds use the data to provide insights on the ESG characteristics of portfolios from current or potential fund managers

ESG trends in Developed Markets

The next chart shows the average ESG Rating of different countries represented as the average of their companies' Ratings. Although FTSE Russell is researching a large number of countries, for simplicity the chart focuses only on the largest markets. Europe, Australia, Canada and the U.S. come out on top whilst the Asian markets come out below the average of all eleven developed markets.

Average ESG Scores by Country



Source: FTSE Russell ESG data as at 31 December 2015 using average ESG Ratings of stocks defined as large and mid cap. 'Global' refers to the average of the eleven developed markets analyzed. Past performance is no guarantee of future performance.

ESG investing is here to stay

There is growing momentum across capital markets to seek and consider ESG data within core investment strategies. In some markets this is more developed than in others, and some institutions are approaching this at a deeper and more sophisticated level than others but the direction of travel is very clear. Investors also have a strong incentive to encourage companies to enhance their ESG disclosure.

ESG factors can relate to individual *values* but many investors are now using ESG to seek long term investment *value*.

For more information about our indexes, please visit ftserussell.com.

© 2016 London Stock Exchange Group plc and its applicable group undertakings (the "LSE Group"). The LSE Group includes (1) FTSE International Limited ("FTSE"), (2) Frank Russell Company ("Russell"), (3) FTSE TMX Global Debt Capital Markets Inc. and FTSE TMX Global Debt Capital Markets Limited (together, "FTSE TMX") and (4) MTSNext Limited ("MTSNext"). All rights reserved.

FTSE Russell® is a trading name of FTSE, Russell, FTSE TMX and MTS Next Limited. "FTSE®", "Russell®", "FTSE Russell®", "MTS®", "FTSE TMX®", "FTSE4Good®" and "ICB®" and all other trademarks and service marks used herein (whether registered or unregistered) are trade marks and/or service marks owned or licensed by the applicable member of the LSE Group or their respective licensors and are owned, or used under licence, by FTSE, Russell, MTSNext, or FTSE TMX. SEDOL is a trade mark of the London Stock Exchange plc.

All information is provided for information purposes only. Every effort is made to ensure that all information given in this publication is accurate, but no responsibility or liability can be accepted by any member of the LSE Group nor their respective directors, officers, employees, partners or licensors for any errors or for any loss from use of this publication or any of the information or data contained herein. No member of the LSE Group nor their respective directors, officers, employees, partners or licensors make any claim, prediction, warranty or representation whatsoever, expressly or impliedly, either as to the results to be obtained from the use of the FTSE4Good Index Series or FTSE ESG Ratings or the fitness or suitability of the Index or Ratings for any particular purpose to which they might be put.

No member of the LSE Group nor their respective directors, officers, employees, partners or licensors provide investment advice and nothing in this document should be taken as constituting financial or investment advice. No member of the LSE Group nor their respective directors, officers, employees, partners or licensors make any representation regarding the advisability of investing in any asset. A decision to invest in any such asset should not be made in reliance on any information herein. Indexes cannot be invested in directly. Inclusion of an asset in an index is not a recommendation to buy, sell or hold that asset. The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional.

No part of this information may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without prior written permission of the applicable member of the LSE Group. Use and distribution of the LSE Group index data and the use of their data to create financial products require a licence from FTSE, Russell, FTSE TMX, MTSNext and/or their respective licensors.

Past performance is no guarantee of future results. Charts and graphs are provided for illustrative purposes only. Index returns shown may not represent the results of the actual trading of investable assets. Certain returns shown may reflect back-tested performance. All performance presented prior to the index inception date is back-tested performance. Back-tested performance is not actual performance, but is hypothetical. The back-test calculations are based on the same methodology that was in effect when the index was officially launched. However, back-tested data may reflect the application of the index methodology with the benefit of hindsight, and the historic calculations of an index may change from month to month based on revisions to the underlying economic data used in the calculation of the index.

This publication may contain forward-looking statements. These are based upon a number of assumptions concerning future conditions that ultimately may prove to be inaccurate. Such forward-looking statements are subject to risks and uncertainties and may be affected by various factors that may cause actual results to differ materially from those in the forward-looking statements. Any forward-looking statements speak only as of the date they are made and no member of the LSE Group nor their licensors assume any duty to and do not undertake to update forward-looking statements.

About FTSE Russell

FTSE Russell is a leading global provider of benchmarking, analytics and data solutions for investors, giving them a precise view of the market relevant to their investment process. A comprehensive range of reliable and accurate indexes provides investors worldwide with the tools they require to measure and benchmark markets across asset classes, styles or strategies.

FTSE Russell index expertise and products are used extensively by institutional and retail investors globally. For over 30 years, leading asset owners, asset managers, ETF providers and investment banks have chosen FTSE Russell indexes to benchmark their investment performance and create ETFs, structured products and index-based derivatives.

FTSE Russell is focused on applying the highest industry standards in index design and governance, employing transparent rules-based methodology informed by independent committees of leading market participants. FTSE Russell fully embraces the IOSCO Principles and its Statement of Compliance has received independent assurance. Index innovation is driven by client needs and customer partnerships, allowing FTSE Russell to continually enhance the breadth, depth and reach of its offering.

FTSE Russell is wholly owned by London Stock Exchange Group.

For more information, visit www.ftserussell.com.

To learn more, visit www.ftserussell.com; email index@russell.com, info@ftse.com;
or call your regional Client Service Team office:

EMEA

+44 (0) 20 7866 1810

North America

+1 877 503 6437

Asia-Pacific

Hong Kong +852 2164 3333

Tokyo +81 3 3581 2764

Sydney +61 (0) 2 8823 3521