Institutional Investors – are you embracing the evolution in responsible investing?

The asset management industry is experiencing an evolution which has been a long time coming – the volume has been turned up on responsible investing and institutional investors are at the heart of this transition. The global pandemic and high-level concerns around climate change have brought a new sense of awareness, the knowledge of long-term risks and opportunities associated with environmental, social and governance (ESG) factors.

In addition to the awareness of ESG factors, regulation is playing an incremental role in investors wanting to invest responsibly with a long-term outlook. In Europe, the European Supervisory Authorities has proposed technical standards on what will need to be disclosed under the Sustainable Finance Disclosure Regulation. In the UK, the government has recognised the long-term impact that climate change is expected to have on pension schemes and the Department for Work and Pensions launched consultation to provide reporting in-line with Task Force on Climate-related Financial Disclosures. This follows closely behind stewardship enhancements introduced to the statement of investment principles which come into play this month.

Over the past six years, Russell Investments has been closely tracking, through our annual ESG survey, how investment managers are evolving their ESG practices. We explore some of the key findings from the 2020 survey and provide some practical guidance to institutional investors on how to embrace this positive evolution.

Amplified focus on ESG factors and climate risk

Russell Investments conducted its ESG survey across 400 global equity, fixed income, real assets and private markets asset managers to assess their attitudes toward responsible investing and how they integrate ESG factors into their investment processes. The survey has evolved over the past several years, enabling deeper insights into trends and how the attitude towards responsible investing has changed. The 2020 survey generated a unique perspective, highlighting the following key observations.

- **Strategic partnerships play a key role in the financial industry's development in responsible investing** - The results reveal that 75% of survey respondents are signatories to the Principles of Responsible Investment (PRI), compared to 72% from the 2019 survey and 63% from the 2018 survey results. Several firms have an extensive list of involvements and advisory roles with initiatives, such as climate change-related, regional-based organisations and stewardship code.
- **Governance remains the dominant factor driving decision making** (Figure 1) - We first asked which ESG factors impact the investment decisions the most. Governance remains the dominant factor. This is no surprise, given that company management has been a critical component in long-term enterprise value.
- **Active ownership continues to rise in prominence** - When asked to identify the primary source of ESG information, engagement activities are viewed as the most frequent primary source of ESG-related assessments. Almost all of the firms with assets under management greater than US$100 billion noted that they always or occasionally included ESG discussions in meetings with senior management.
- **ESG accountability** (Figure 2) Only 22% of the respondents have portfolio performance measures for portfolio managers and/or analysts with direct ties to ESG-profile or climate-risk criteria. This shows that ESG profile accountability is weak among key investment professionals, suggesting that ESG impacts alone have less weight to investment performance outcome than the hype of ESG integration suggests. Despite the weak accountability, we believe it is essential for asset managers to integrate ESG within the investment process.

Figure 1: Which ESG factor impacts your investment decision the most?

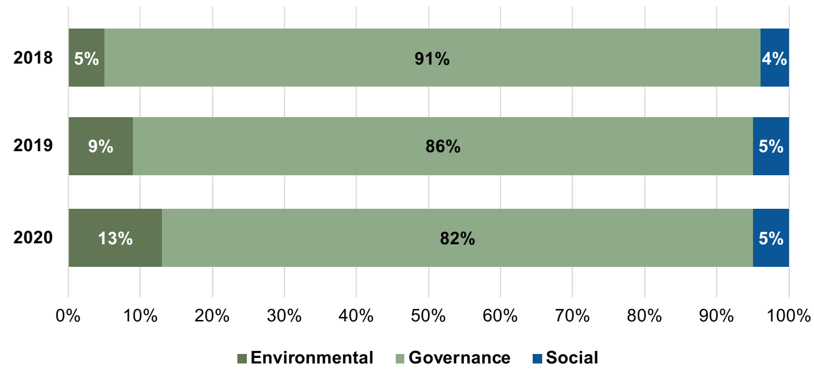
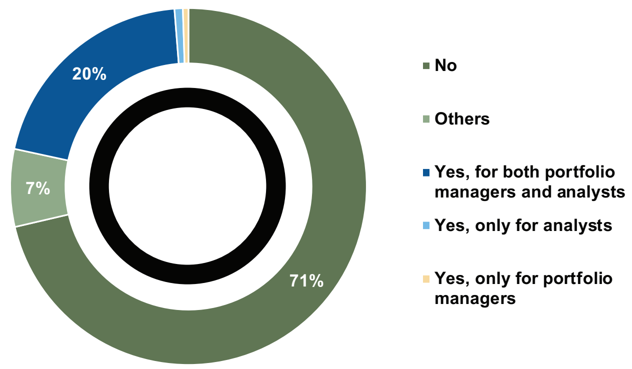


Figure 2: Do you use any portfolio performance measures that have direct ties to ESG profile or climate-risk criteria?



Institutional investors are at the heart of the responsible investing evolution

We have observed from our ESG survey that an increased number of managers are gathering ESG-specific assessments into their investment process. Despite the increase, the degree of ESG integration and the methodologies vary, especially by region, by firm asset size and by asset class.

The lack of credible and reliable data remains a stumbling block, but our research shows that this is an area to expect further rapid growth and enhancements. Despite this there are some tangible steps that institutional investors can take to embrace this evolution:

1. Engage with key industry initiatives

Strategic partnerships play a key role in the financial industry's development in responsible investing. Engagement with key initiatives (for example, the PRI) are important and involvement can help influence how the industry develops.

Call to action: Check which initiatives your asset managers are affiliated with and to what degree. If they are not signed up to key initiatives, then understand why.

2. Understand how your underlying managers are taking ESG factors into consideration

Investment managers have evolved rapidly in how they consider ESG factors into their investment process. This has been driven by the importance of ESG factors in improving risk-adjusted returns, client demands and regulatory pressure.

Call to action: Understand how your underlying managers are taking ESG factors into consideration by asking for transparency around their processes, data vendors, as well as voting and engagement activity. Stock specific stories also help further understand if the underlying portfolio is consistent with their ESG philosophy and process.

3. Evolve your quarterly reporting to be better informed

We observe a growing trend of asset managers buying data from an increasing number of providers and building their own in-house views. In addition, asset managers are increasingly aware of the importance of climate change risk to investors, regulators and the bottom lines of the corporations they own.

Call to action: While much of the data and modelling of climate change is in an infantile stage, the choices are rapidly increasing. We encourage institutional investors to start measuring key risks and for this to form part of their regular quarterly updates.

The Responsible Investing evolution is here to stay. Embrace it. The Russell Investments 2020 ESG Manager Survey findings can be viewed at: **russellinvestments.com/uk/esg-survey**

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