Five Questions CIOs Should Ask Investment Managers About ESG

by Wellington Management's ESG Team

As risk management has drawn more attention in recent years, institutional investors who have integrated environmental, social and corporate governance (ESG) considerations into their process have put themselves in a better position to assess risks and opportunities in their portfolios. In our view, keeping track of how companies handle ESG issues is an alpha tool that also performs an important risk function – and we have found it to be a powerful early-warning system.

To learn more about investment managers' ESG approach, we recommend asking these five questions:

1. What is your philosophy for integrating ESG risks within your investment process for all asset classes, from both a risk-management and a return-enhancing perspective?
2. How effectively do your portfolio managers engage with company management teams and offer best practices on ESG issues?
3. Do you have access to ESG data (such as company safety records, waste-disposal practices and executive compensation), and do you have experts capable of interpreting the impact of ESG risks on your portfolios?
4. How often do you exercise your right as a shareholder to vote proxies and voice concerns in order to influence companies to change their corporate behaviour?
5. Are you a signatory to the United Nations-supported Principles for Responsible Investment (PRI), and do you actively promote these best practices?

Investment managers who engage in these ways will have a deeper understanding of companies' ESG perspectives and will be better positioned to incorporate any findings into their investment analysis. While a lot can be learnt about companies from external sources, direct engagement allows investment managers to assess the nuances of a company's ESG risks and opportunities. For example, if a company appears to be struggling with significant ESG issues, it's important to recognise exactly what those issues are, how they might negatively affect investment results in the short or long term, and how those risks can be reduced. If a company is particularly good at managing ESG issues, more can be learnt about their best practices and the opportunity for positive performance.

Christina Zimmermann, manager of ESG Research at Wellington Management, and Tim McCarthy (standing), director of Corporate Governance, meet with a portfolio manager.

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In addition, company management teams can seek feedback on their issues of concern. This two-way process allows companies and shareholders continual opportunities for improvement and can provide portfolio teams with actionable ideas to incorporate into their investment decisions.

Increasingly, we find that ESG issues have a quantifiable impact on the performance of the companies we invest in. Recent examples include:

Environmental: A food and beverage company reported saving US$15 million per year* by improving water efficiency.

Social: An Asian car manufacturer expects to spend over US$300 million* on product recalls due to safety issues.

Corporate governance: An oil and gas company recognised a loss of nearly US$2 billion* due to acts of corruption.

Given the impact that issues like these can have on financial performance, we recommend that CIOs and other institutional investors work with their investment managers to comprehensively integrate ESG analysis into the investment process.

*Data sourced from specific company reports.

ARE YOUR INVESTMENT MANAGERS ASKING COMPANY MANAGEMENTS ABOUT CYBERSECURITY?

Issues relating to CEO compensation and board diversity are generally the priorities when it comes to corporate governance risks, and cybersecurity is sometimes overlooked. Poor management and board oversight of cybersecurity risks can adversely affect business results, brand loyalty and stock performance.

We believe that cybersecurity is not a solvable problem, but rather an issue that requires implementation of "detect and respond" strategies, where companies investigate anything that is not "normal business". Assurances from a management team that their company is "protected" are warning signs of an immature programme. Large retailers and banks are the most vulnerable, though health care companies are increasingly being targeted.

Sample engagement questions that we ask company managements include:

➲ How do you monitor what is normal business behaviour, versus what could be a cyberattack?
➲ Who has oversight of cybersecurity? Do they report to the board?
➲ How often does your company engage with industry peers on security trends and best practices?
➲ Do you use third-party consultants or security experts to test your systems?
➲ What does your crisis-management plan look like?
➲ Has your company suffered a successful cyberattack? If so, what changes did you make after the breach?

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To learn more about ESG integration and engagement at Wellington Management, visit:
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