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TOPICS OF INTEREST

Verus

Agreeing on ESG:

How to Build Board Understanding and Agreement Around ESG Issues and Program Implementation

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Summary

Following explosive growth in environmental, social, and governance (ESG) investing, many institutional investors have expressed interest in understanding whether ESG principles might have a role in their own investment portfolios, and if so what that role might be. But with so many issues involved, and so many different types of investors, developing and implementing an ESG philosophy and policy is much easier said than done. The range of appropriate outcomes from this conversation could vary from the decision to simply avoid ESG issues altogether to a decision to fully engage with ESG issues at every step of the portfolio construction and management process. This paper will shed light on the difficulty institutional investors face as they embark on their journey toward implementing a thoughtful ESG policy that fits their specific organization and is designed to help them cut through the clutter by providing a detailed, practical "soup-to-nuts" methodology to determine the best policy for their organization.

Introduction

Following a period of momentum building and the broadening acceptance that ESG principles could be implemented within a standard fiduciary framework, growth in ESG investing has gained increasing momentum over the past several years. According to the Global Sustainable Investment Alliance, ESG investing assets reached more than $30 trillion worldwide at the end of 2018 and doubled over the previous seven years.

In the U.S. alone, ESG investing assets topped $12 trillion, making up about a quarter of professionally managed assets[1].

This topic is clearly one that is potentially on the table for discussion for every institutional investor, but that raises important questions about whether and how to proceed. Should each board feel an obligation to discuss it? How should they approach such a discussion? What are the possible outcomes? Is it reasonable to reach a conclusion that ESG is not appropriate for the organization? How do boards ensure the discussion around these issues is inclusive of all points of view and not dominated by a passionate few? Is it reasonable to assume boards can just put the topic on the agenda with the expectation that friendly conversation will naturally lead to consensus and an appropriate outcome?

In "The Judgmental Waiter," a Sound Thinking piece from earlier this year, we established that our neutrality in the ESG discussion is essential to letting our clients freely implement their ESG beliefs in their portfolios without imposing our own viewpoints[2]. We recognize that our clients' views on ESG are diverse, and our advice around ESG is highly customized to reflect that fact.

Sounds simple, right?

There are really two key reasons why what may seem simple in theory becomes difficult in practice.

First, there are many worthy ESG objectives, but a decision-making body must reach true consensus on what goals to pursue – and indeed whether pursuing any ESG objectives at all is appropriate for the organization. This may be easier for some entities than others. For example, a faith-based organization may focus on simply excluding stocks in particular industries such as those of companies involved with alcohol, tobacco, gambling, and weapons, and may determine that this is not only appropriate but in fact core to their mission. In another case, an eleemosynary organization such as an endowment or foundation may choose to focus a portion of its investment portfolio on companies that support its specific mission. At least these entities typically exist based on a shared set of beliefs or views on the positive societal impact they are trying to effect. On the other hand, imagine how difficult this consensus-building exercise becomes with a pension plan with the diversity of views of individual Board member let alone the views of the multitude of plan beneficiaries.

The table below represents just one of many examples of potential ESG criteria that can be used by decision makers interested in ESG investing[3].

POTENTIAL AREAS OF IMPACT

Environmental Issues	Social Issues	Governance Issues
Climate change and carbon emissions	Customer satisfaction	Board composition
Air and water pollution	Data protection and privacy	Audit committee structure
Biodiversity	Gender and diversity	Bribery and corruption
Deforestation	Employee engagement	Executive compensation
Energy efficiency	Community relations	Lobbying
Waste management	Human rights	Political contributions
Water scarcity	Labor standards	Whistleblower schemes

While it is perhaps easy to agree on the merits of these high-level descriptors, it is also easy to see how a group of individuals might get bogged down trying to prioritize them and then further define them to a level of detail required for effective implementation within an investment program.

Which brings us to our second challenge, implemention. Investors tend to use six types of methods for integrating ESG considerations into the investment process. These methods are not mutually exclusive, and are as follows.

1. **Exclusionary screening** is the oldest and most straightforward ESG method – it is also known as negative screening. As the name implies, exclusionary screening refers to avoiding securities of companies or countries based on specific ESG criteria. For instance, excluding stocks of companies connected to alcohol, tobacco, or gambling products or services, or avoiding securities due to ethical, human rights, or environmental concerns.

2. **Best-in-class selection** is an investment style that focuses on companies with strong or improving ESG metrics relative to industry or sector peers. Unlike the exclusionary screening method, best-in-class selection does not exclude entire categories of securities. Best-in-class selection is also known as positive selection or positive alignment.

3. **Active ownership** refers to employing shareholder power to influence the activities or behavior of investee companies. Corporate engagement and proxy voting are the two primary tools for this approach. Note that active ownership is not necessarily synonymous with activist investing, as the latter tends to be a more aggressive and confrontational approach to advocating change.

4. **Thematic investing** refers to focusing investments in themes or assets that address specific issues related to ESG, such as clean technology, renewable energy, food,

water, education, health care, and agriculture. A thematic investing approach focuses on expected long-term trends that may be social, industrial, or demographic in nature.

5. **Impact investing** involves investing with the primary goal of achieving specific and measurable social or environmental benefits in addition to a financial return. In fixed income, green bonds and social impact bonds, which finance environmental and social projects, respectively, are examples of dedicated impact investment vehicles.

6. **ESG integration** refers to explicitly considering a range of sustainability and ESG-related risks and opportunities in concert with traditional financial analysis. ESG integration is meant to create a more holistic approach, where ESG information is used throughout the investment process, from security selection and valuation to portfolio construction and risk management.

Not only must a decision-making body decide which of these approaches it will use to meet its ESG vision, it must also determine which portion of the investment portfolio to activate, address policy issues such as program objectives, governance, and performance monitoring, as well as update current investment mandates and select new ones, as appropriate. And all of the above should be continuously considered within the context of fiduciary duty -- with a changing regulatory environment it is important that the investor's legal advisors are in the loop in the discussion and that they are comfortable with whatever outcome reached.

So now what?

All the challenges stated above can be managed and worked through by applying a comprehensive, common-sense, and step-by-step approach we go on to describe below. As described this approach assumes the decision-making body is considering ESG for the first time and uses a defined benefit pension fund as the selected investment entity, but its use is broadly applicable across plan types, and some of the steps may be abbreviated or ignored altogether, depending on the specific circumstances or current status of the decision-making body.

It is important to note this process does not imply or build momentum for any particular outcome at any step along the way. That is to say the best and most appropriate policy for any given organization, whether it is to do nothing or go all in, will be developed through open and honest discussion, respectful consideration of the views of all stakeholders, and a thorough evaluation of the attendant issues. The important thing is not the specific end destination reached, but the fact that the process by which it was reached was made in the right way and the appropriate issues considered.

PHASE 1 – TELL ME ABOUT IT

Before making any final decisions, or even entering into active discussion, the Board should

be thoroughly educated on the issues surrounding ESG and the implementation of an ESG program. Education topics to consider include:

- History of ESG
- Terminology
- Areas of impact
- Fiduciary implications
- Legal implications
- Recognition of different stakeholders
- Investment program implications
- Potential investment performance implications and performance drivers
- Implementation approaches, including differences across asset classes
- Implementation planning

Education may be provided in part or in whole by the plan's investment consultant if they possess sufficient expertise, and subject matter experts may be called upon to address specific topics in greater depth. Both investment and legal components need to be understood, as guidance from regulators in this space has changed through time. It is important to find objective, neutral third parties to conduct the education so as not to introduce bias into the process -- there is a fine line between education about the issues and advocacy for certain specific approaches. The Board may choose to devote an entire session to the topic of ESG education, followed by facilitated discussion. Here, a skilled (and again neutral) third-party facilitator can apply structure and guidance to ensure all viewpoints are expressed and help drive the Board to consensus around shared beliefs and appropriate next steps.

At this point, appropriate next steps may include the adoption of an ESG-neutral policy or further consideration of what type of affirmative ESG program may be appropriate for the organization. If the former, the process ends with codification of the consensus viewpoint. If the latter, additional steps are required.

PHASE 2 – BEST LAID PLANS

If following sufficient education and thorough discussion, the Board chooses to proceed towards adopting a non-neutral ESG policy, a high-level project plan should be developed that includes key project stages, a timeline, and roles and responsibilities. The project plan becomes a living document that is flexible and adaptable, and detail will be added as the initiative evolves and issues are identified and resolved. We recommend a formal project management framework to ensure the process runs smoothly and that it is appropriately viewed as a significant change to the way the organization approaches investments.

PHASE 3 – MISSION IMPOSSIBLE

This critical step is all about reaching further consensus on what positive outcomes the decision-making body will be trying to achieve, and this may be the most difficult part of the entire process. A first step is to carefully consider which stakeholders will have input into the decision. For a pension plan for example, will the collective view of plan participants be given consideration, or will the Board take full responsibility for prioritizing the value of various ESG objectives? If participants are included, a reasonable approach may be to implement a well-designed survey to get the general sense of priorities of the broad participant population, which may become an input into the decision-making process.

A dedicated Board meeting led by a trained facilitator is an efficient means to drive consensus regarding which priorities to pursue. The key activities to follow in such a session are:

- Identify the possible areas of impact (those listed above or the U.N. Sustainable Development Goals are a good starting point);
- Conduct a selection exercise (we prefer a structured individual selection followed by structured aggregation to elicit and consider all existing viewpoints); and
- Through this gain a sense of the Board's initial prioritization, which is then followed by clarifying discussion to obtain the necessary level of detail (should include an attempt to identify potential unintended consequences).

The output of this session is then converted into a clearly articulated mission statement that acts as the guiding principle for the entire ESG program. The mission statement includes and is supported by specific and measurable goals, which provide context for additional elements of the plan's investment philosophy contained in the Investment Policy Statement, (e.g., "We endeavor to identify and participate in investment opportunities that help us achieve our target rate of return and also have a positive impact on global society without harming the environment."). It is important again to note that throughout this process there is not a perception that a particular conclusion is "the right answer". The end result must be one reached by true consensus, as all Board members must abide by the final ESG policy going forward and will have to be able to support that ESG policy to other stakeholders once implemented.

PHASE 4 –BY DESIGN

Once the mission statement is complete, the next step is to create the portfolio design elements through which the mission will translate to changes to the actual investment portfolio. Activities during this stage include:

- Identify the asset classes most suited to achieving the specific goals articulated in the newly created mission statement;
- Conduct quantitative modeling to estimate risk/return impact of various implementation

scenarios; and

- Narrow implementation options to those most appropriate to the implementation scenarios defined above.

For example, if the stated mission is to improve environmental sustainability, and one of the specific goals is to alleviate water scarcity, then a reasonable change to the portfolio may be to apply the “Positive/Best-in-Class Screening” implementation approach by initiating a private equity investment in a water technology fund.

Another example may be if the stated mission is to improve social well-being with a specific goal of reducing child labor around the world, then a reasonable change to the portfolio may be to apply the “Negative/Exclusionary Screening” implementation approach to companies known for using child labor at any point along their supply chain.

The output of this step is an ESG investment strategy that describes what level of assets within which asset classes will be utilized to achieve the stated mission, as well as what implementation approach(es) will be used for each part of the portfolio identified. There may be conclusions drawn during this exercise which causes the Board to reflect on the practicality of the approach being proposed: if this is the case then further discussion of the goals of the program is appropriate. Part of this design conversation should involve an understanding of the tools that will be used to monitor compliance with the new approach being adopted.

Once the new investment strategy is approved, the Investment Policy Statement is updated to reflect the new program elements. Areas of the IPS which will likely be impacted include:

- Investment Philosophy;
- Enterprise Objectives;
- New section on ESG Program, including monitoring the success of the program; and
- Performance Monitoring.

PHASE 5 – SPREAD THE WORD

While we list this as a discrete step, experienced project managers know that otherwise well-implemented initiatives often fail because of poor communication. A detailed communication plan should be developed at about this stage of the process. The plan will identify key stakeholder groups, develop key messaging for each, and assign timing, media, and individual responsibility for delivery of key messaging. Also, management and implementation of the communication plan should be assigned to a single, senior person within the organization.

PHASE 6 – BACK TO THE DRAWING BOARD

Now that we know what the future portfolio will look like, the investor will need to develop a detailed implementation plan that takes the portfolio from the current state to the new future state. Additional details to be added to the plan include a gap analysis and a staged timeline of activities required to fill the identified gaps, such as:

- Revising current manager mandates;
- Conducting searches for new managers;
- Transitioning assets; and
- A regular schedule for assessment as to outcomes achieved from the new approach.

Conclusion

While discussing ESG can seem daunting and controversial, if one follows a disciplined approach, taking it one step at a time and carefully working to ensure all voices are heard and the broader implications understood, an end state can be achieved where the investment program reflects the consensus of key stakeholders on the subject of ESG, and where that end consensus is both in line with the goals of the organization and compatible with the broader fiduciary and financial obligations involved. The key steps to achieving such an end state are: educate Board on ESG issues; identify core values; determine implementation approach; codify as investment policy; implement; and communicate. Naturally, the devil in this process is in the details, as many of the issues are controversial ones where reasonable people may disagree but an experienced advisor acting in the best interest of the client, rather than simply promoting a particular point of view on the issues involved, can effectively facilitate the decision-making body through the entire process.

Notes & Disclosures

1. *Source: US SIF Foundation's 2018 Report on US Sustainable, Responsible and Impact Investing Trends*
2. *Source: Toner, Ian. "The Judgmental Waiter: Who Decides? ESG in Institutional Investing." Sound Thinking, March 2020*
3. *Source: CFA Institute, ESG Issues in Investing: A Guide for Investment Professionals*

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