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THE PURSUIT OF SUSTAINABLE RETURNS: INTEGRATING ENVIRONMENTAL, SOCIAL, AND CORPORATE GOVERNANCE FACTORS AND SUSTAINABILITY BY ASSET CLASS

MARSH & McLENNAN COMPANIES

Investment that considers sustainability isn't about changing the world; it's about understanding how the world is changing.

At Mercer, we believe that an investment view that goes beyond traditional financial analysis and considers a wide range of risks and opportunities — including sustainability factors such as good governance, and environmental and social impacts — is more likely to create and preserve long-term investment capital. Increasing awareness of the growing and aging population, natural resource constraints, and a shifting public sentiment and regulatory landscape on many environmental and social issues present risks and opportunities to investors.

In Mercer's *Investment Framework for Sustainable Growth*, we distinguish between the financial implications (risks) associated with environmental, social, and corporate governance (ESG) factors, and the growth opportunities in industries most directly affected by sustainability issues. Mitigating emerging risks requires flexibility, foresight, and fresh thinking about risk management. At the same time, investors should adapt their strategies to capitalize on new opportunities.

Mercer's framework follows a typical investment process: beliefs, policy and processes, and portfolio.

Mercer's portfolio reference guide, *The Pursuit of Sustainable Returns: Integrating Environmental, Social, and Corporate Governance Factors and Sustainability by Asset Class*, is summarized on the following pages. The full guide outlines the drivers for addressing sustainable growth trends at a portfolio level for each major asset class.

Incorporating investments that reflect a greater level of ESG integration or sustainability themes into the asset allocation framework is an area in which there is growing interest. We believe regulatory pressures to meet global standards of ESG integration and responsible stewardship will only increase in the coming years and we therefore see this as an area of increasing importance over the long-term for our clients.

The table on the following page summarizes Mercer's view on the relevance of ESG to risk/return in each asset class, the current state of ESG integration as reflected by Mercer's ESG ratings across mainstream strategies, and the range of sustainability-themed investment strategies available.

	ESG POLICY		
INTEGRATED MODEL	BELIEFS	PROCESSES	PORTFOLIO
RESEARCH INTO ESG	• Experience in the PAST. • Stakeholder's needs TODAY. • Expectations of the FUTURE.	• Regulation. • Industry practice • Governance.	• ESG ratings. • Themed strategies.
DEVELOP WORKPLAN	• Beliefs workshop. • Ongoing trustee education • Member engagement.	• Embed ESG into existing processes. • Active ownership.	• Portfolio reviews • Allocations.

	Relevance of ESG to risk/return drivers	Current state of ESG integration (distribution of ratings)*	Availability of sustainability-themed strategies**
Private markets	Medium/high	Medium/high	Low/medium***
Infrastructure	High	High	Medium
Timber	High	High	Medium/high
Agriculture	High	Low/medium	Medium/high
Property	High	Medium/high	Low
Listed equity	Medium	Medium	Low/medium***
Fixed income	Low	Low	Low
Hedge funds	Low	Low	Low
Impact investments	High	High	Low

* Refers to the percent distribution of ESG 1- and 2-rated strategies in GIMD™, when available.
** Refers to the number of institutional quality sustainability-themed strategies relative to the respective mainstream universe in GIMD.
*** These are larger universes relative to other asset classes and therefore availability of thematic strategies may be low relative to the universe, but potential high in absolute number.
NB: Low: <5%; Low/medium: 5-10%; Medium: 10%–20%; Medium/high: 20%–40%; High: >40%

WHAT IS ESG INTEGRATION?

ESG is the term used to describe the more intangible factors that investors consider in the context of corporate behavior, given these factors can have a material financial impact. ESG analysis can help to identify the long-term risks and opportunities. By disclosing ESG practices and defining a strategy, a company demonstrates transparency, awareness of risk, strategic forward-thinking, and strong management — qualities that investors consider important. Investors are increasingly adopting frameworks to consider ESG risks to sustainable growth within their investment decision-making, such as those highlighted in the table on the right. Many of these factors are not necessarily captured by looking at standard investment fundamentals.

ESG factors can be incorporated into manager allocations by leveraging Mercer's ESG ratings for investment strategies. These ratings are standard within Mercer's manager research process across most asset classes. We have been assigning ESG ratings at the investment-strategy level since 2008, assessing the extent to which asset managers integrate ESG factors and active ownership activities into their investment decision-making framework. An ESG 1 rating reflects an investment strategy that actively incorporates ESG factors and active ownership into the decision-making process. An ESG 4 rating suggests little to no action by the portfolio manager to integrate such factors.

ENVIRONMENTAL
Climate change and greenhouse gas emissions Energy efficiency Resource scarcity Pollution Water availability
SOCIAL
Health and safety Population/consumption Stakeholder relations/reputation Supply chains Working conditions
GOVERNANCE
Accounting and audit quality Board structure Remuneration Shareowner rights Transparency

ESG1	ESG2	ESG3	ESG4
• Leader in the integration of ESG factors and active ownership into core processes.	• ESG factors integrated into analysis but do not drive idea generation. • Strong approch to active ownership.	• Limited progress with respect to ESG integration albeit with signs of potential improvement. • Some degree of active owership.	• Little or no integration of ESG factors and active ownership into core processes and no strong indication of future change.

WHAT IS SUSTAINABILITY-THEMED INVESTING?

As an investment theme, sustainability aims to identify the growth opportunities of companies that provide solutions to challenges such as natural resource constraints, population growth and demographic changes, and changes in public sentiment and the evolving policy response to a range of environmental and social issues.

The term "sustainability" is becoming more widely used and the most common definition is taken from a 1987 United Nations report that defined sustainable development as meeting the "needs of the present without compromising the ability of future generations to meet their own needs."[1] Sustainability-themed investment strategies generally focus on a range of sectors or companies whose products and services are specifically aimed at contributing to positive environmental and social development.

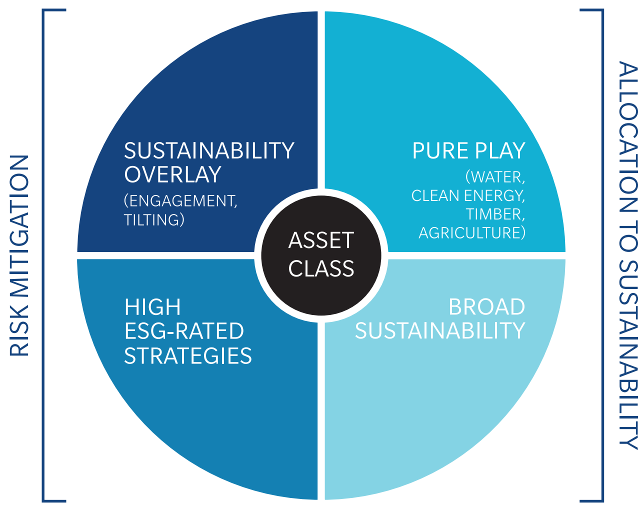
Although sustainability themes are wide-ranging and new themes are emerging, some of the most prevalent investment ideas include:

- Environmental themes, focused on solutions to environmental problems, increasing efficiency, and addressing resource scarcity:
  - — Renewable energy.
  - — Energy efficiency and clean technology.
  - — Water and waste management.
  - — Timber and agriculture.
- Social issues, encompassing demographic trends such as increasing and aging population, consumption patterns for a rising middle class, investment in low-income areas (such as impact investing), and health issues:
  - — Health care.
  - — Education.
  - — Sustainable goods and services.

Environmental themes can be accessed through either pure-play investment strategies (which focus on one particular theme) or through blended investment products. Social themes are typically captured through broad sustainability strategies (which combine both environmental and social themes).

IMPLEMENTING ESG AND SUSTAINABILITY ACROSS ASSET CLASSES

The following diagram highlights the various approaches to sustainability that can be implemented across asset classes.



1 United Nations World Commission on Environment and Development. *Our Common Future*, 1987.

- Sustainability overlay: This may include re-weighting or tilting passive index constituents or engaging with companies based on sustainability issues; typically most applicable within the listed equity asset class.
- High ESG-rated strategies: We assign ESG ratings at the investment-strategy level, enabling clients to identify managers that actively integrate ESG into investment decision-making, and those that do not.
- Pure play: This kind of allocation focuses primarily on one particular sustainability theme, such as water, clean energy, timber, or agriculture.
- Broad sustainability: This focuses on strategies that target a range of environmental and social trends as a key investment driver. In addition to the pure-play themes, they often include social opportunities in health, education, and other sustainable goods and services.

Consultants and clients can utilize this framework to evaluate the options available within each asset class of a client's portfolio.

THE CASE FOR ESG INTEGRATION

Increasing academic and industry evidence indicates that integrating ESG factors and active ownership into the investment process can improve risk-adjusted returns. For example, a 2012 Deutsche Bank review of more than 100 academic studies concluded that companies with higher ESG ratings had a lower (ex-ante) cost of capital in terms of debt and equity.[2] A separate report from the London Business School analyzed an extensive proprietary database of ESG engagements with US public companies over a 10-year period and found that these engagements were followed by a one-year abnormal return that averages 1.8%, comprising 4.4% for successful and 0% for unsuccessful engagements.[3]

Furthermore, factoring in ESG considerations is now generally considered a piece of the best-practice puzzle. Key global initiatives and bodies such as the CFA Institute also support the practice and highlight the emerging trends that can impact corporate performance and the brand value and reputational risks of not taking ESG considerations into account. In the US, for example, the Sustainability Accounting Standards Board is developing sustainability accounting standards aimed at helping publicly listed companies disclose material factors that are in compliance with the Securities Exchange Commission requirements. The standards also give investors comparable, standardized data on these increasingly significant sustainability risks and opportunities that are not reflected in financial statements.[4]

THE CASE FOR INVESTING IN SUSTAINABILITY THEMES

Investing in sustainability themes offers attractive opportunities to access the growth potential of companies providing solutions to the challenges of resource scarcity, demographic changes, and changes in the evolving policy response to a range of environmental and social issues. Exposure to sustainability themes can also be used to hedge traditional portfolio allocations against the negative impacts of climate change. There are a number of potential diversification benefits from investing in sustainability themes:

- A long-term investment horizon, with more compelling risk/return trade-offs as the macro drivers take effect over the long term.
- Exposure to revenue opportunities, which are typically under-appreciated or under-recognized by the market.
- Exposure to emerging technologies as an energy market transformation takes place.

Key investment drivers include:

- Resource demand.
- Demographic changes.
- Market transformation.
- Impact of policy and regulation.
- Social and environmental benefits.

APPLICATION BY ASSET CLASS

The majority of the environmental opportunities can be accessed via private markets (such as private equity) and real assets (such as infrastructure). However, thematic listed equity managers are also tapping into both environmental themes and capturing broader social opportunities, such as population growth and demographic changes.

From Mercer's perspective, the best managers can identify the sweet spots in broad sustainability themes to find investment opportunities from under-recognized and

2 Deutsche Bank Group. *Sustainable Investing: Establishing Long-Term Value and Performance*, 2012.
3 Dimson E, Karakas O, Li X. "Active Ownership," 2013, available at http://hbs.me/1DyNlbc accessed 12 August 2014.
4 Bloomberg M, Shapiro M. "Give investors access to all the information they need," *Financial Times*, 19 May 2014.

under-appreciated factors that have the potential for increases in valuations over the longer term.

Differentiating sustainability-themed strategies from those with a high degree of ESG integration within a diversified portfolio is important. Not all managers running sustainability-themed strategies will have a focus on integrating ESG issues into their investment process. This is more apparent in some of the pure-play, sector-focused equity strategies, in which managers could be more focused on the revenue potential of a company within a particular theme (such as renewable energy), without necessarily focusing on how these companies are addressing environmental and social issues within their own operations and business models.

We believe that manager selection is key in accessing these thematic opportunities. The best investment managers generate ideas that are superior to those of their peers. For example, within the environmental space this means that, in addition to an excellent understanding of traditional investment topics, these managers must have in-depth knowledge of the specific sectors in which they are investing, including market and regulatory expertise. Moreover, we find that investment teams that draw individuals from a variety of different backgrounds (both investment and industry) have the potential for greater success.

The full reference guide provides detailed guidance on the relevance of ESG to risk and return drivers, and how investors are implementing these within the following asset classes:

- Private Markets.
- Infrastructure.
- Timber.
- Agriculture.
- Property.
- Listed Equity.
- Fixed Income.
- Hedge Funds.
- Impact Investments.

It is important to differentiate sustainability-themed strategies from those with a high degree of ESG integration within a diversified portfolio. *Mercer's full report on The Pursuit of Sustainable Returns: Integrating Environmental, Social, and Corporate Governance and Sustainability by Asset Class*, explores the relevance of ESG factors to risks and returns, the current state of ESG integration, and the range of sustainability-themed investment strategies, across each asset class.

CONCLUSION

When undertaking asset class reviews, consultants and clients are encouraged to consider investment opportunities by:

- Reviewing the ESG ratings for existing or prospective strategies and considering tilting toward high-ESG-rated strategies that also have a strong alpha rating.
- Considering an allocation to sustainability-themed strategies across asset classes.

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