Sustainable Global Equity Managers

Observations from our search and tender

Summary

In 2014/15 the Environment Agency Pension Fund launched a search for new managers for its global sustainable equity mandate, after significant team changes with the existing manager. The EU tender and the broader search process provided a detailed insight into the state of the global sustainable equity market. Key observations are:

- There are a large number of managers that are now integrating environment social and governance (ESG) factors into their investment process in a reasonably thorough way, with suitable analytic tools and combining it with good governance. This means that for **asset owners, implementing responsible investment is easier than ever before.**
- Several specialist and mainstream managers are leading the way on innovation. One development of note was managers seeking to directly link their engagement and active ownership activities with their portfolio construction.
- The quality of more quantitative or systematic approaches to ESG integration and sustainable portfolio management is growing, reflecting improved data.

In the search, we paid particular attention to the link between ESG analysis and financial return: managers who are able to use sustainability to add value. Typically this means anticipating the market on ESG factors, not merely following it. We were particularly helped in this analysis with new tools developed by Prius partners.

The outcome of our search for sustainable equity managers that meet our needs is:

- We invested c£90m in a fund managed by Ownership Capital, based in Amsterdam;
- We awarded a c£90m mandate to Union Investments based in Frankfurt; and to ensure maximum flexibility from the EU tender process:
- We appointed without immediate funding two further managers Mirova – Natixis, of Paris, and Hermes Investment Management based in London.

They join the other managers already looking after mandates for the EAPF with a focus on sustainable, long term investing: Generation Investment Management, Stewart Investors (formerly First State Stewart) and Impax Asset Management. Standard Life and Robeco AM also have very strong stewardship capabilities. Between them, they set demanding standards for the new managers.

Overall the EAPF believes it has a strong set of managers who understand sustainability and can deliver good investment performance for the Fund over the long term.

Identifying our needs

Our objective was to replace an existing sustainable equity mandate, which was nearly ten years old. Although it had done well, clearly the market has moved on significantly. So our aim was to identify the most progressive yet credible ideas in sustainable equity investing. As well as a high level of ESG integration, and robust stewardship, we were looking for a more strategic understanding of sustainability and how it can drive value.

The box below summarises the specification used. We made the mandate broad as we wanted to see the best ideas from the market.

Sustainable Equity Mandate specification

The Environment Agency intends to award contracts to one to three investment managers to manage a portfolio of sustainable, global, listed equities on a long term basis to cover a total amount of assets of between £75m and £250m.

Sustainability: managers are expected to have a long term strategic approach to sustainability, and to integrate environmental, social and governance (ESG) considerations broadly into the portfolio. Managers are likely to have a strong commitment to non financial research which should go beyond (but likely include) short term considerations of ESG risk factors and standard corporate governance considerations, and look to understand longer term potential drivers of value, with an appropriate attention on opportunities as well as risk.

Broad exposure across regions, sectors and company sizes is preferred. The EAPF is not seeking narrowly based sector or thematic approaches – such as water, renewable energy or clean technology funds, although an allocation to these areas may form part of an overall strategy, and expertise in these areas may well be useful. Similarly funds which rely solely on negative screening on ESG issues are not of interest.

Geographical Scope: global equities. This may or may not include emerging markets.

Types of assets: The investments are expected to comprise primarily listed equities. Limited use of cash, derivatives, and equity linked investments may be used for efficient portfolio management. A modest allocation to unlisted companies is acceptable (but not required).

Objective: The portfolio(s) is to be managed with an objective of exceeding the long term return from global equities, over a 3 to 10 year timeframe, as defined by one of the leading conventional equity market indices e.g. MSCI World or FTSE All World. Outperformance targets should be specified. Absolute return benchmarks (or hybrids) will also be acceptable.

Governance: Managers are to be responsible for voting and engagement with portfolio companies, in line with best practice and general principles of good long term stewardship.

Risk Management: Managers are expected to have robust risk management processes and systems. The understanding of risk should extend beyond a relative risk against an index to a more fundamental evaluation of underlying business risks, consideration of long term ESG risks, and the ability to consider risk in absolute terms (against cash or liabilities).

Industry Involvement: Managers are expected to show commitment to responsible and sustainable investment, e.g. UNPRI membership, other involvement.

Experience: We would prefer suppliers or their teams to have run portfolios to the proposed investment process for a minimum of two years but will consider newer approaches. Experience at previous institutions or on similar products will count towards this assessment as long at the core process is comparable. We will allow proposals where certain aspects may be contingent on appointment, or where authorisations etc may be pending.

The Selection Process

We started by reviewing the market for sustainable equity management in depth, identifying best practice and key managers. As part of this process, we identified an opportunity to invest in a pooled fund run by Ownership Capital (see profiles) which we felt was particularly innovative. We also identified that there was a lot of potential interest from managers for the EU tender process.

We launched the formal part of our search in September 2014 with an advert placed in the EU official journal, calling for brief expressions of interest covering 9 key areas, as below. Note that sustainable investment considerations were integrated into most of these areas, rather than treated separately.

Category	Weight	Section	Weight (of category)	Criteria	Weight (of section)	Weight (of total)
Economic & Financial Cplty	15%	Organisational strength	100%	incl size & stability	100%	15%
Technical Capability	85%	Team and Resources	35%	Staff/resources	65%	19.3%
				RI commitment	35%	10.4%
		Investment Process for sustainable equities	45%	Inv. philosophy	20%	7.7%
				Investment Process	30%	11.5%
				Risk management	25%	9.6%
				Governance	25%	9.6%
		Products and Performance	20%	Products	50%	8.5%
				Performance	50%	8.5%

60 responses were received which was at the top end of expectations, and a **record response** for any fund manager tender by the EAPF. The respondents covered a wide range of suppliers: established specialist sustainable equity boutiques; some new boutiques with innovative approaches to sustainability; several mainstream investment managers with strong ESG expertise and commitment; and a handful of organisations from the hedge fund or alternative investment space.

We provide an overview of the submissions we received below – split into "mainstream" managers and specialists in sustainable investment. We were supported throughout the search and tender process by our investment consultants Mercer, whose manager ESG ratings cover a large part of the industry. **Note that our comments reflect our evaluation at the time of the tender** – many managers are developing rapidly and addressing weaknesses, so it is essential investors get updated information, before reaching any decisions.

Mainstream Managers

A large number of what could be considered mainstream managers responded to the tender. Many of these managers demonstrated the key elements of a responsible investment approach: clear evidence of ESG integration, with ESG factors being imbedded into investment analysis, and a commitment to stewardship and active governance. We regard the following names as broadly falling into this category.

Aberdeen AM Acadian AM (UK) Allianz Global Investors* Amundi AM Axa Baillie Gifford BlackRock Candriam Investors* Comgest Deutsche A&WM F&C (now GMO)	First State Investments* (now Stewart Investors) Goldman Sachs AM Henderson Glbl Investors HSBC Global AM ING IM Investec AM Jupiter AM Kleinwort Benson Investors Lombard Odier AM (Eur) Pictet AM*	RBC GAM UK Robeco* Royal London AM Sarasin & Partners* Schroders Standard Life Investments Threadneedle Investments (now Columbia Threadneedle) UBS Global AM Union Investment* Vontobel AM*

Note AM = Asset Management, IM – investment Management. List includes those managers scoring over 6 on first round assessments, not identified as specialist.

For asset owners wanting a general global equity manager with a level of capability in responsible investment covering integration and stewardship all of the above managers are likely to be worth considering, although individual strengths will vary.

The implication is clear: with many leading fund managers now capable in responsible investment; there are no significant impediments to implementing responsible investment for asset owners. It has never been easier to take a responsible investment approach in an equity mandate.

For the EAPF, however, we look for something extra: for example, – a strategic understanding of sustainability or an enhanced ability to extract value from ESG factors. Several managers we felt delivered on that, often with a more sustainability focused product, or a greater level of sustainability resources. Those managers, listed below, were taken through to the next stage.

Allianz Global Investors	Extensive ESG capability focused on identifying long term risks and opportunities, builds best in class global portfolios with some exposure to improving companies.
Candriam Investors Group	Quantitative manager with commitment to sustainability, builds best in class portfolio with good risk controls.
First State Investments	See Profiles, note global product submitted here.
Pictet Asset Management	Filter best ESG companies (well governed, offering sustainable products / services, established corporate responsibility) then select high quality, defensive names.
Robeco	Rotterdam based asset manager able to integrate RobecoSam sustainability research in quantitative manner with strong governance capabilities.
Sarasin & Partners	Look within broad strategic themes for companies with a sustainable business model; able to deliver for shareholders and stakeholders; and an attractive valuation.
Union Investment	See Profiles.
Vontobel Asset Management	Build portfolios with stocks in top quartile for return on capital and industry position and that pass proprietary ESG thresholds.

Specialists in sustainable investment

The alternative to a mainstream manager is a specialist / or boutique fund manager focused on sustainable investing. Here ESG integration is built into the process, and the scope for innovation and ideas is not constrained by the limitations of a large organisation. We were pleased to see the presence of several such managers in our tender, and a level of continued innovation. Four such managers were taken through to the next stage.

Alliance Trust Investments	Long standing sustainable investor, strong commitment to sustainability, and good governance.
Active Earth	New boutique, high conviction, disciplined quality focus, employing a systematic approach to identify and value responsible quality companies.
Bank J. Safra Sarasin	Long standing, Swiss based sustainability specialist, offering sustainable and responsible mandates, using integrated research and their well known sustainability matrix.
Boston Common	Women-owned, U.S.-based manager that enhances financial analysis by integrating proprietary ESG criteria and shareowner engagement to manage sustainable investment portfolios.
Hermes Investment Mgt*	See profiles.
Impax Asset Management	See profiles, broader product proposed here.
Mirova (NGAM UK Ltd)*	See profiles.
La Française / Inflection Point Capital Management *	New joint venture, enhanced systematic approach built around Strategically Aware Investing concept. Strong emphasis on companies' strategic management capabilities.
Osmosis Investment Mgt	Systematic best of sector approach, based on Model Of Resource Efficiency, using quantitative data to build high quality sustainable large-cap portfolios.
Sustainable Insight Capital Mgt	A new boutique, SICM tests and uses ESG variables for their share price forecasting power, and incorporates these in an optimised portfolio which minimises unintended risks.
WHEB Asset Management*	Established sustainable equity specialist with deep commitment and understanding of sustainability, multi thematic.

* shortlisted

Sustainable equity managers tend to score highly on investment ideas, and on commitment to sustainable investment, as might be expected. Conversely, many scored less well on organisational strengths, although several are addressing this, e.g. though strategic partnerships. The other area where such managers sometimes scored less well was on governance and stewardship, particularly the more quantitative managers: this reflects the fact that smaller organisations often have limited resources to devote to engagement, however, institutional investors still expect active stewardship of their holdings.

Systematic Managers

One feature that was noticeable was the growing use of systematic and quantitative approaches to the portfolio. This is a welcome development and reflects the rising quantity and quality of ESG data available to portfolio managers. Systematic managers are usually excellent at managing risks, using factor biases well and building up diverse portfolios, while offering lower management fees.

Systematic managers face a couple of challenges: firstly that in a mandate such as this, the focus is more on long term absolute returns, rather than against a conventional benchmark – which tends to be the focus of much of their analysis. Secondly, although ESG data has improved considerably, much of it is already quite dated by the time it is published, so care is needed to extract forward looking value out of it.

Evaluation: getting quantitative

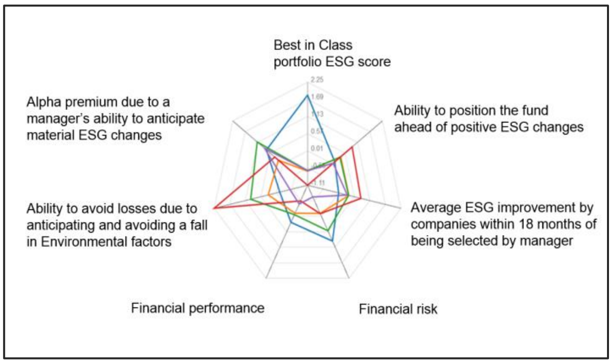
We took 12 managers through to a full tender process. This stage looked in more detail at the products they proposed and the process to be used, the team and organisation, their fees, and their performance history.

In particular, we investigated their ability to add value through anticipating improvement in the investment company's sustainability performance. The thesis here that a truly skilful SRI manager should be able to anticipate public assessments of a company's ESG performance (as supplied by the ESG rating agencies), and use this to generate alpha for the portfolio – merely following the rating agencies in stock selection is not evidence of manager skill.

This analysis was conducted by Prius Partners using their analytic engine "FLAME". This looks at a manager's individual trading decisions and what happened to those stocks in subsequent months, both in terms of ESG ratings and relative performance. With a truly skilful manager, both these should trend up, as the companies ESG perception improves and the market rewards that improvement with a higher rating. This analysis helped us distinguish between managers, particularly among those managers who focus on how companies operate (as opposed to what they do). It helped identify those managers who really were good at adding value. The assessment scores several different criteria, which can be weighted and combined to give a single ranking. Top contributing holdings/trades were highlighted for each key criteria, which helped the discussion with managers about their investment style.

The spider chart provides an example of the analysis showing how different managers scored on seven different criteria.

This research supported the rest of our analysis, and based on the complete evaluation, we decided to appoint Union Investments, Hermes and Mirova – Natixis, with Union given funds to manage immediately. Profiles of these managers and our other sustainable equity managers (to provide the full picture) are shown below.



Final Thoughts

The market for sustainable equity managers has moved on a long way in the last decade, with ESG integration now standard at most good equity managers, and a variety of managers exploring new approaches and ideas to sustainable equities, through more systematic approaches to analysis or by using engagement and governance to inform portfolio construction. The quality of sustainable investment is much higher, and is being improved all the time.

For asset owners this is good news – apart from the not insignificant challenge of having to sift through a large number of candidates – competition and quality is increasing, and all asset owners could give consideration to an allocation to sustainable equities. More significantly, there are no constraints stopping asset owners ensuring that in their main global equity mandates their managers are properly engaging with responsible investment.

For managers, these developments are more mixed. Clearly there is more competition, but the market is hopefully growing fast. More significantly, with more and more mangers integrating ESG considerations these factors are likely to be being discounted by the market more quickly, making it more challenging to extract value. Increased discipline and sensitivity to what is already in the price is likely to become more important. However, we are confident the best managers will continue to thrive.

What worked for us – some thoughts for asset owners

Seek good examples and case studies (not the obvious ones!).

Ask the fund manager the ESG questions not the RI/ESG specialists - to evidence whether the fund managers is serious about ESG.

Challenge on whether they are ahead of the market in understanding the impact and financial consequences of ESG factors.

Explore the links between stewardship and investment process – do they feed off each other?

Use UNPRI transparency reports and assessment to reduce questions and enhance due diligence.

For further information about the tender please contact Mark Mansley on mark.mansley@environment-agency.gov.uk

Important notice

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The EAPF's Sustainable Equity Managers: Profiles

Generation Investment Management
Generation's investment philosophy is based on the conviction that sustainability risks and opportunities directly affect long-term business profitability. Generation integrate equity analysis with sustainability research to identify businesses that will deliver value over the long-term given global trends and challenges. They build a concentrated portfolio of high quality businesses whose sustainability practices, products and services are consistent with a low-carbon, fair and safe society.

Hermes
The Hermes Global Equity ESG Fund invests in companies with positive environmental, social and corporate governance criteria. Their key strength is the integration of ESG assessments – supported by Hermes renowned engagement service (EOS) - directly into the heart of the investment process. The strategy favours companies who are managing their ESG risks better than their peers, or companies who are demonstrating an increasing focus on ESG issues.

Impax Asset Management
Established experts in managing funds targeting environmental and resource efficiency markets, with detailed knowledge of the key sectors. Their environmental specialist strategy builds a small/mid cap portfolio across alternative energy, energy efficiency, water, waste, food and agriculture related markets. Impax has also designed a methodology to measure the positive environmental impact of its equity portfolio.

Mirova (part of Natixis)
Mirova's investment process combines 3 approaches: a search for thematic investment opportunities, a thorough analysis of all risks (financial and ESG), and dialogue/engagement at both company and industry level to foster their vision of sustainable development. The strategy is unconstrained and has a quality style bias, not in terms of sectors, but in terms of company profile, because sustainability equally encompasses financial and ESG criteria.

Ownership Capital
Ownership Capital is an independent Dutch equity manager that generates superior returns through active long term ownership of a concentrated portfolio of companies, which takes inspiration from private equity. They have a ten-year investment horizon that enables them to be genuinely engaged owners of high-quality companies, creating long-term value by encouraging good governance and sustainable business strategies.

Stewart Investors (formerly First State Stewart)
Edinburgh based fundamental, highly focused manager, emerging market experts, aiming to generate long-term above average returns by investing in high quality companies able to benefit from, and contribute to, sustainable development. Sustainability is a key driver of returns and embedded into research and engagement. There is no formal negative screening and an emphasis on avoiding losses.

Union Investment
Sustainability is deeply rooted in the cooperative values of Union Investment, and the firm operates in a spirit of partnership, openness, responsibility and consideration for the future. Their mandate blends Union Investment's sustainability research skills (including active voting and engagement in line with principles of good, long-term stewardship) with a high-conviction, value seeking approach to target long-term outperformance versus global equity markets.