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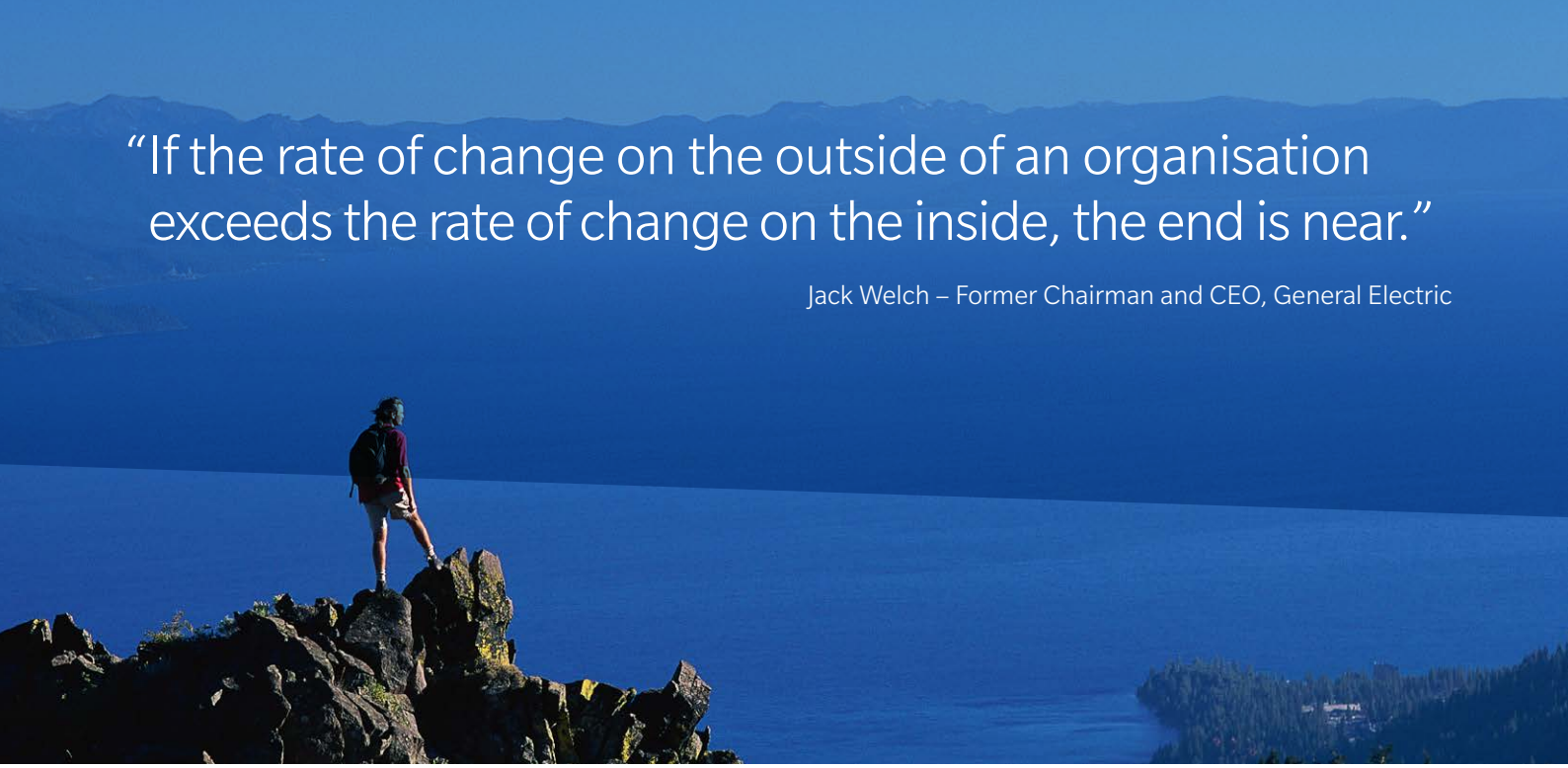
AN INVESTMENT FRAMEWORK FOR SUSTAINABLE GROWTH

CAPTURING A BROADER SET OF RISKS AND OPPORTUNITIES – INTEGRATING ESG AND SUSTAINABILITY THEMES

MARSH & McLENNAN COMPANIES



"If the rate of change on the outside of an organisation exceeds the rate of change on the inside, the end is near."

Jack Welch – Former Chairman and CEO, General Electric

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

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, presents risks and opportunities to investors.[1,2]

Mercer's investment framework for sustainable growth distinguishes between the financial implications (e.g. 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 capitalise on the new opportunities being created.

Including this additional perspective is a gradual evolution, not revolution, of an existing investment process, within your existing governance budget. The framework follows a beliefs, policy and process, portfolio approach that can help to:

- **Mitigate portfolio risk**, by ensuring ESG factors are captured throughout investment processes
- **Demonstrate active ownership**, to improve the governance of underlying investments and markets, directly or via manager monitoring, through voting practices and engagement
- **Construct portfolios that target long-term returns**, with alpha or beta allocations to sectors and markets expected to perform well, given sustainability considerations.

1 World Economic Forum *2014 Global Risks Report* http://reports.weforum.org/global-risks-2014/

2 Mercer's 2011 *Climate Change Scenarios - Implications for Strategic Asset Allocation* http://www.mercer.com/climatechange

ENVIRONMENTAL

- Climate change and GhG emissions
- Energy efficiency
- Resource scarcity
- Pollution
- Water availability

SOCIAL

- Health and safety
- Population/consumption
- Stakeholder relations/reputation
- Supply chains
- Working conditions

GOVERNANCE

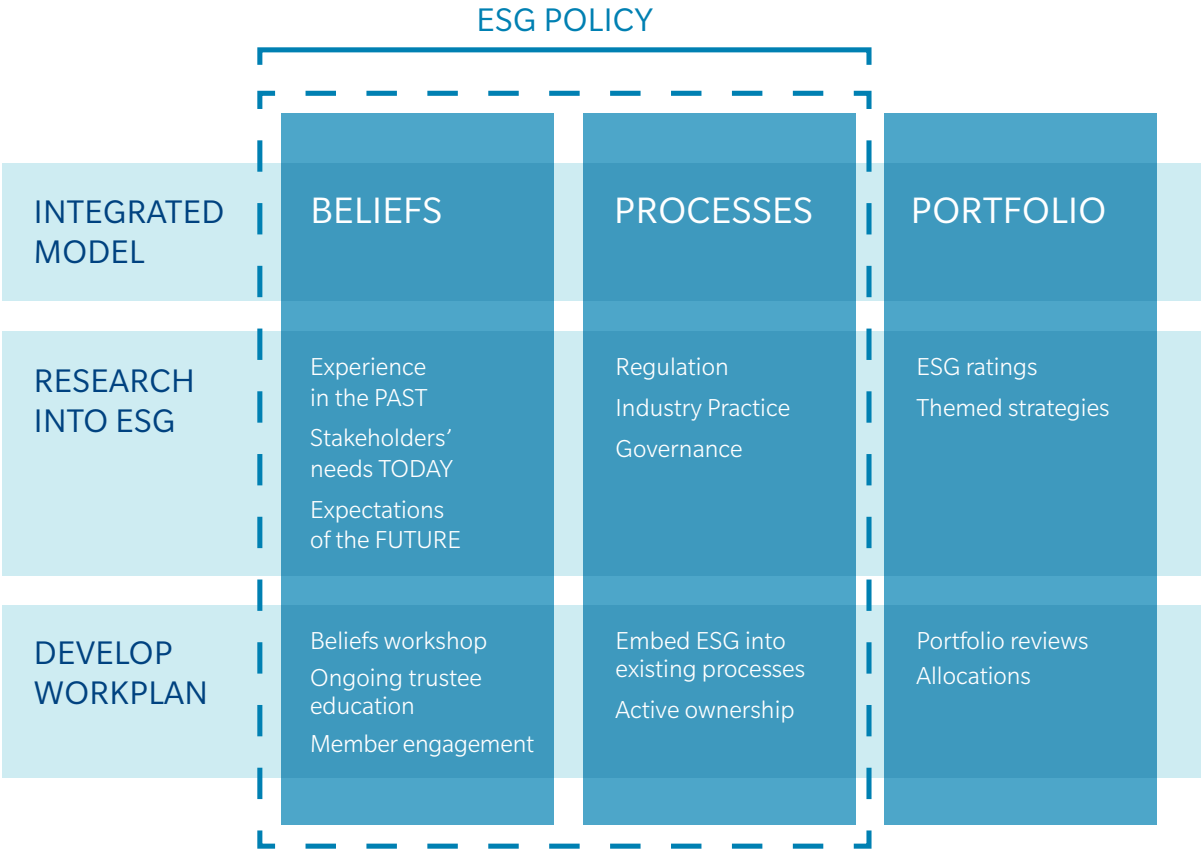
- Accounting & audit quality
- Board structure
- Remuneration
- Shareowner rights
- Transparency

CONSTRUCTING AND IMPLEMENTING THE FRAMEWORK

Applying sustainable growth principles is most effective when it is integrated into standard investment processes, providing an additional layer of insight and oversight. The framework below identifies where ESG and sustainability considerations sit within the typical '**Beliefs**, **Processes**, **Portfolio**' investment approach.

We recommend a three step process, as illustrated below.

1. **Review your beliefs**
2. **Update your policy and embed it within your processes**
3. **Create a workplan that incorporates ESG factors and sustainability themed strategies**



Each investor's approach will be unique, reflecting priorities based on the requirements of stakeholders (including regulators), investment structure and approach, available resources and governance budget.

STEP 1 – BELIEFS

An investment strategy is underpinned by the investment beliefs of the stakeholders who design it. These beliefs reflect long-term views of how investment markets work and therefore how value is created. Clearly articulating your beliefs regarding ESG and sustainability gives you a broader perspective on long-term risks and opportunities and means you are less reactive when market conditions change, which represents a strengthening of the investment governance process.

When reviewing ESG and sustainability beliefs, Trustees and investment staff should consider the following:

ESG INVESTMENT CASE

The growing body of literature demonstrating ESG factors can improve risk-adjusted returns [3,4,5,6,7,8]

REGULATION

Changing regulatory requirements [9]

STAKEHOLDERS

Changing stakeholder expectations on particular environmental, social and governance topics [10]

PEERS

Increased peer activity, e.g. signatories to the UN Principles for Responsible Investment and clients using Mercer's ESG ratings in selecting and monitoring managers, together with trends in data availability and index development [11]

FUTURE POSSIBILITIES

Research anticipating developing themes, e.g. climate change, resource scarcity, human rights, which investors can elect to prioritise based on perceived materiality, stakeholder connection, investment exposure and opportunity for impact.

3 Mercer for the United Nations Asset Management Working Group (2007) *Demystifying Responsible Investment Performance* http://www.unepfi.org/publications/investment/index.html and Mercer (2009) *Shedding Light on Responsible Investment Approaches, Returns and Impacts*

4 DB (2012) *Sustainable Investing: Establishing Long-Term Value and Performance* https://www.db.com/cr/en/docs/Sustainable...shing-long-term-value-and-performance.pdf

5 Deloitte (2013) *Finding the Value in Environmental, Social and Governance Performance* http://www.deloitte.com/us/findingthevauleinesg

6 Ambachtsheer, J, Fuller, R, Hindocha, D (2013) *Behaving Like an Owner: Plugging Investment Chain Leakages* Rotman International Journal of Pension Management, Vol. 6 Issue 2 Fall 2013 http://www.rijpm.com/journal/journal_s/40

7 Dimson, E., Karakas, O., Li, X. (2013) *Active Ownership* Social Science Research Network Working Paper Series

8 MSCI (2013) *ESG Integration – Building Thought Leadership* http://www.msci.com/products/esg/esg_integration_-_building_thought_leadership.htm

9 APRA (2014) *Superannuation Reforms 2011 – 2013* http://www.apra.gov.au/Super/Pages/Superannuation-reforms-2011-2013.aspx and the Financial Services Council (2014) *UK Stewardship Code* https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx

10 350.org (2014) *Fossil Free Campaign* http://350.org/ and the Asset Owners Disclosure Project (2014) *Climate Ratings* http://aodproject.net/

11 PRI (2014) http://www.unpri.org/about-pri/about-pri/history and Mercer (2014) *ESG Ratings: 5,000 and Counting* http://www.mercer.com/articles/ESG-ratings-update.

At Mercer, we believe investing should consider a wide range of risks and opportunities, including sustainability factors such as good governance, environmental and social impacts on assets, as well as the associated policy and regulatory implications. We believe this approach is more likely to create and preserve long-term investment capital.

STEP 2 – POLICY AND PROCESS

Once beliefs regarding ESG integration and sustainability are established, policy documents should be updated as appropriate and consideration given to implementation within each stage of the investment process.

Further detail is provided on the following pages on portfolio implementation by integrating ESG and sustainability themes. If you would also like to review your approach to active ownership, particularly share voting and engagement, please advise your consultant or local contact and we can discuss this in more detail with you.

STEP 1

DEVELOP BELIEFS IN CONTEXT

- Fiduciary role
- Regulation, stakeholder and peer context
- ESG beliefs

STEP 2

POLICY AND PROCESS DEVELOPMENT

- ESG policy
- Risk/return impacts
- Stakeholder preferences

STEP 3

RESEARCH THE PORTFOLIO OPPORTUNITIES

- Risks/opportunities from structural trends e.g. climate change
- ESG ratings, sustainability themed strategies

STEP 4

DEVELOP ASSET ALLOCATION STRATEGY

- ESG related assumptions
- Targeted themed allocations and alpha opportunities

STEP 5

IMPLEMENT PORTFOLIO

- ESG ratings in manager selection
- New investments/weights
- Valuations

STEP 6

MANAGE AND MONITOR PORTFOLIO

- Active ownership
- Improve ESG credentials
- Review and reporting

STEP 3 – PORTFOLIO

Incorporating ESG factors and sustainability themes across asset classes can be considered in the context of risk mitigation and proactive allocations.

Sustainability overlay: This may include reweighting passive index constituents or engaging with companies based on sustainability issues. This is most applicable for listed equity.

High ESG ratings: 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 allocations: This 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.

ESG RATINGS

Incorporating ESG factors within portfolio decisions typically leverages Mercer's ESG ratings for managers. These are standard within Mercer's manager research process across most asset classes. There are now over 5,000 strategies with a Mercer ESG Rating which captures to what extent a manager includes ESG factors and active ownership principles throughout their investment process.

1. APPLY MERCER ESG RATINGS

- Screen for highly rated strategies from both a research and ESG perspective e.g. select only strategies that are A rated and ESG2 or ESG3 and above, where possible
- Review the average rating for your portfolio as a whole, compared to the ratings universe

2. UNDERTAKE ADDITIONAL DUE DILIGENCE

- Select potential strategies based on ESG ratings and then ask additional ESG questions during the final due diligence stage
- Identify managers with the capacity to improve on ESG, and drive this change during your monitoring process.

This research is increasingly being utilised by clients as an additional tool for differentiation in the manager selection and review process. Different approaches exist for incorporating ESG factors. It could mean simply applying a minimum standard for ESG ratings (e.g. ESG3, applied either at the individual strategy level or the average across a whole portfolio), or could include more structured due diligence and engagement.

For example, a growing number of clients are reviewing the average ESG rating for their managers and setting targets to improve this score. Your consultant will be able to discuss the ESG ratings in your reports and manager research notes, or you can search for these directly if you have access to Mercer's Global Investment Manager Database (GIMD).

Approximately 10% of the 5,000+ rated strategies receive the highest ESG ratings (ESG1 or 2).[12]

12 Mercer (2014) *ESG Ratings: 5,000 and Counting* http://www.mercer.com/articles/ESG-ratings-update.

SUSTAINABILITY THEMES

We have seen a growth in client interest and in managers identifying opportunities in sustainability as a theme. These strategies isolate one or more environmental and social demand or risk drivers and identify investments that are best positioned to benefit from these.

Risk and return expectations for each asset class are typically the same as a 'mainstream' equivalent, given the fundamental asset class drivers are the same. However, policy and regulatory developments, market inefficiencies, and associated environmental and social benefits, are all additional considerations. Access via listed or unlisted options will depend on the usual client considerations such as timeframes, liquidity, fee budgets, current portfolio diversification etc.

In the listed markets the opportunity set typically includes equities, with only a limited number of fixed income 'green bond' strategies currently available:

Equities

- **Pure Play**: water (including water infrastructure, technologies and utilities); renewable energy and energy efficiency; food and agriculture.
- **Broad Sustainability**: A broad market approach, with focus on the range of pure play themes as well as social demographic opportunities in health, education, and other sustainable goods and services.

In the unlisted markets the opportunity set includes:

- **Private Equity, Private Debt**: Businesses in environmental sectors such as energy, waste, water, materials and systems, at both the technology development stage (e.g. 'cleantech') and growth stage businesses looking to expand.
- **Infrastructure**: Most likely to include clean energy infrastructure e.g. renewables, but can also include waste recycling and energy efficiency centres.
- **Agriculture**: Commodities, including grains, fruits, nuts and livestock, that taps into food and energy related trends.
- **Timber**: For its renewable and low carbon credentials.

While the property asset class does not tend to explicitly access new sustainability themes, ESG factors are now captured within best practice property portfolio decisions e.g. water and energy usage.

There are over 700 investment strategies with sustainable opportunities now available in GIMD.

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WHAT NEXT?

This paper outlines a framework for applying sustainable growth principles. We can help you to review your beliefs, policies and processes to capture this additional perspective , accompanied by an implementation approach that suits your requirements.

A more detailed reference guide on integrating ESG and sustainability themed investment drivers and opportunities by asset class is also available. Please contact your consultant or local contact to receive a copy and to discuss how you could implement these approaches within your portfolio.

Contact information: www.mercer.com/ri

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