ESG culture crucial to integration says innovating funds
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Some of responsible investing's most sophisticated adherents have moved from token aspirations to attempting to imbed environmental, social, governance integration into all their investment decisions. *Top1000funds.com* talked to Dutch asset manager PGGM and Danish fund ATP, which are both widely regarded as ESG leaders, about how they have integrated ESG into their investment processes. While both funds are considered leaders in the ESG integration, their approaches are somewhat different.

PGGM manages more than €105 billion ($153 billion) and its head of responsible investment, Marcel Jeucken (pictured), says it makes a clear delineation between what is actually ESG integration and what, in fact, may be an investment overlay. "You have to have fundamental knowledge about the underlying asset, otherwise you cannot integrate ESG factors," Jeucken says. "Passive strategies don't coincide with pure ESG integration, you need to look for material ESG factors." Jeucken says it takes a "narrow focus on ESG integration", seeing it as a subset of its responsible investment activities. But a focus on the material effect of ESG factors means ESG is integral to any actively managed investment decision PGGM takes. In equities this means a focus on ESG integration in its actively managed portfolio, which is worth about $2.9 billion and concentrates on between 20 and 30 companies at a time, which is what Jeucken describes as the "responsible equity portfolio". "We look at ESG factors and focus very actively on engagement with companies to improve performance, and we take strong positions in companies we invest in," he says. For the remainder of its equity portfolio PGGM is what Jeucken calls "benchmark investors" where it predominately follows market capitalisation indexes.

"If you don't have fundamental analysis it is difficult to do ESG integration," he says. "So for benchmark investments a team of 11 people focus on voting and engagement with companies." Jeucken says this type of ESG integration is labour intensive and PGGM needs to have a big enough stake in the investment. "We don't believe that in very liquid markets we can really add value through active management, so that is the reason why we have this approach," he says. The time horizon of an investment is also an important consideration in pure ESG integration, with concerns such as climate change weighing more heavily on long-term investments than on investments where PGGM will change its position in the short to medium term, Jeucken says. PGGM also looks at engaging at the market level and has recently held discussions with the Securities Exchange Commission in the US and the Gillard Government in Australia over its carbon tax proposals.

Partner and global head of Mercer's responsible investment business, Jane Ambachtsheer, however, sees ESG considerations being built into passive equity investment strategies as one of the key areas of innovations in the ESG space over the next two to five years. "There will be passive vehicles that investors do employ in the future, whether it's an investable product or whether it's a data feed that they bring in themselves to have an active overlay into their own indexation, these are things people are starting to look at," Ambachtsheer says. Ambachtsheer identified private equity, infrastructure and fixed income as the asset classes where it was most likely there would be innovation in ESG integration in the next two to five years. In fixed income this includes looking at ways to build in a company's ESG performance when assigning risk to a relevant corporate debt instrument. This could potentially lead to cheaper borrowing costs for top ESG performers. Ambachtsheer says other innovations could look at ways of building in sustainability overlays into fixed income investments. An example would be a climate change overlay that looked at industry, regional or country specific risk. While public companies are facing increased engagement from investors, Ambachtsheer says institutional investors are also demanding more transparency around ESG from private equity. As “top of the food chain” Ambachtsheer says funds are in a particularly powerful position when it came to pushing for substantial improvements in ESG reporting and performance by private equity managers. In terms of real assets Ambachtsheer identifies a growing body of evidence that ESG considerations, especially around climate change and carbon exposure, could have a substantial impact on returns.

Both PGGM and ATP have built in ESG considerations into their real estate portfolios. As long-term investors they see the carbon footprint of the buildings they own as a crucial material factor in the potential success of the investments.
While Jeucken is a member of PGGM’s investment committee, he says the responsible investing arm of the asset manager is not there to veto projects or do in-depth analysis of particular investment decisions. “In terms of new investment proposals, the investment team doesn’t have to come to the ESG department for permission. If they did I wouldn’t give it. I am here to ask, ‘did you ask the right questions’. Or, I ask them with specific questions where they need the input of RI team specialists” he says. “Show me that you asked those questions, that you integrated ESG and then it is up to the investment committee.” ATP’s head of responsible investment, Ole Buhl, sees a greater diversity of approaches to ESG integration emerging in the coming years.

It is a view echoed by Ambachtsheer who says the greater diversity in approaches to ESG is driven not only by a proliferation of potential products, approaches and strategies but also by the increasing demand from funds to have bespoke ESG processes that fit their particular needs. Buhl says the culture of an organisation and the tailoring of ESG practices to the individual fund’s investment approaches and philosophies is vital to true integration and acceptance of ESG into the investment process. Buhl says the consideration of ESG factors in the investment process has long been seen as just a natural part of making investment decisions at ATP. Rather than outsourcing ESG analysis or screening, Buhl says the fund tries to do as much of its ESG-related work in-house. Also, responsibility for ESG integration is not taken by a dedicated ESG team or department but is seen much more as part of the overall job of portfolio managers**.** The equity team has been at the forefront of this approach, and Buhl says they have been building in ESG considerations for more than a decade, as part of its investment process. “We have a certain overall tendency and a tradition among portfolio managers to take these ESG factors into consideration,” Buhl says. “I think it also has a lot to do with the focus on these things, both from our sustainability reporting but also from senior management,” he says. “There is a culture, in the real sense of the word. It has evolved. We had our first guidelines for socially responsible investing in 1997 but we didn’t start by policing a lot of investments. Because it wasn’t something that came from an outside source or consultant it has always been part of the investment department and always part of investment discussions.” Buhl says this avoids a situation where investment staff are potentially hostile to ESG staff or outside consultants. Rather than investment staff seeing ESG as a potential constraint that could hamper returns, it is instead seen as a fundamental part of the investment process, says Buhl. ESG integration at ATP takes many forms and can be seen even at the micro-level, with its sustainability report detailing how the staff canteen ensured an 80:20 mix of vegetables and meat in all meals for both sustainability and the health of its employees. More than 95 per cent of ATP’s equity portfolio is held in Danish companies.

Similar to PGGM, this has allowed the fund to be active owners which have real influence in the companies they invest in. Likewise, they say true ESG integration is resource intensive and involves a deep understanding of the companies or investments they are involved in. Its "do-it-yourself" approach also extends to its hedge fund investments, with the fund preferring to build its own hedge fund and strategies. On the other hand at PGGM the investment team looks at the underlying ESG factors that may influence a hedge fund's strategy. It also ensures that voting and engagement issues are consistent between its hedge fund investments and its equity investments where they may have the same underlying investments. Buhl says the fund has similar ESG approaches for its corporate fixed income investments and its foreign equity holdings. It conducts a general screen of its investments, looking for potential ESG risks. These ESG considerations are in line with general international agreements that Denmark is a signature to and the principles enshrined in the UN Principles for Responsible Investment. "We are looking for extraordinary high risk which we are not being paid for," he says.

By SAM RILEY

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